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Governing Europe

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Volume I

The Single Market and Economic and Monetary Union

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The Single Market and Economic and Monetary Union

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Part I Introductory

1 Introduction

Peter Ludlow

Beyond 1992

When CEPS' 1989 Annual Conference was planned, it was still considered somewhat eccentric to discuss the European Community's future 'beyond 1992'. The realisation that the EC was indeed serious about its plans to create an internal market had, after all, only relatively recently begun to take root both inside and outside the Community, and there was still a widespread sense, particularly among those for whom the crisis years were a fresh and painful memory, that the newfound confidence was brittle and vulnerable. In these circumstances, the wise counselled cautious concentration on the details of the internal market programme and the avoidance at all costs of theological discussions which might revive ancient fears and divisions. Mrs. Thatcher's celebrated speech at Bruges towards the end of 1988 was cited as the first blast in a reactionary campaign against further European expansion which could, it was alleged, spread across the Community as a whole.

We remained convinced, however, that this diagnosis of the Community's condition was unnecessarily timid. The internal dynamics of European integration and external pressures were bound, we believed, to confront the Community with questions going far beyond those answered in the internal market programme itself. The first Delors Commission would go down in history as the one that launched the 1992 programme; the second would be judged by its success in defining and grappling with the questions of beyond 1992. Of the latter, four seemed particularly important: *Economic and Monetary Union; the management of the Internal Market once achieved; common foreign and security policies; and political accountability and democratic control.*

We did make one concession to the more prudent amongst us: the original conference title 'The Government of Europe' was dropped, and in its place the somewhat hazier and therefore, presumably, less threatening phrase of 'Governing Europe' appeared. As 1989 progressed, however, whatever initial anxieties we may have had that the conference papers would be of no more than academic interest were swept aside in a manner and at a speed that was hardly credible.

First, *Economic and Monetary Union* was put firmly on the agenda with the publication of the Delors Committee report, the decision of the Madrid Council to initiate Stage One in 1990, and, by the time our conference took place, the near-certainty, subsequently confirmed, that an intergovernmental conference to negotiate Stage Two would be convened before the end of 1990.

Second, *the management of the internal market* too was made a central issue by the Commission itself in the middle of 1989, when the Commissioner responsible for the internal market, Mr. Bangemann, reported to the Council his growing concern that the encouraging progress in the legislative programme could still be set at naught by the dilatoriness of the member states in actually implementing and enforcing Community law.

As for the need for *common foreign and security policies*, regarded even by some of those that Ambassador Froment-Meurice and I talked to in the autumn of 1989 as somewhat remote, events in the last quarter of the year swept the question to the very top of the agenda. Although the collapse of the Soviet empire and the totally-unexpected reemergence of the 'German question' were the most conspicuous catalysts of the debate, the latter had already begun before the full extent of the crisis of Communism became apparent, not least because of the fundamental review of policy priorities by the new administration in Washington.

Political accountability and the democratic deficit could hardly be ignored against the background of an agenda such as this. Once again, however, 1989 gave its own special twist to the story with the election of a new European Parliament, aware of the advances already made by its predecessor, and manifestly committed to still greater progress in the new five-year period ahead of it.

To say that the events of 1989 confirmed the agenda that we had envisaged at the beginning of the year does not of course mean that we believed that the Community would effortlessly respond to the challenges before it. On the contrary, precisely because developments have been so fast and dramatic, there is a danger that political élites in the member states, who remain through the Council the final determinants of Community policy, will prove unable to grasp the essential linkage between consolidation of the Community and the stabilisation of Europe as a whole. There have been signs - particularly, though not exclusively, in London - that this is the case. Fortunately, however, the Community's leaders, at least when together, seem fully aware that the need to 'deepen' the EC is greater than ever. As a well-placed observer noted after the Brussels meeting of foreign ministers at the General Affairs Council in February 1990, so insistent had the foreign ministers been on the fact that their best hope of influencing events in Europe lay in strengthening their cooperation, that their conversation resembled at times an evangelical gathering rather than a formal Council meeting.

The approach: from functional integration to Union

The 1989 Annual Conference was built around four papers on functional themes: *Concrete Steps towards Monetary Union; The Making of the Single Market; Towards a European Foreign Policy; and European Defence Collaboration.*

The choice of the functional approach to a debate about European Union was quite deliberate. The Community method has always been to advance towards Union by agreement on practical objectives to be achieved either through a clearly defined programme (such as the dismantling of internal tariffs in the 1960s or the White Paper of 1985), or through creative interpretation of capaciously drafted Treaty articles. Such an approach was both sensible and in many respects inevitable. Despite a common cultural heritage, EC 6, EC 9 and EC 12 are not 'natural' units in the way that Italy or Germany were (more or less) in the nineteenth century. The question of what the Community is, or who is in the Community, has from the beginning been answered at one level in terms of member states who accepted common rules for agreed purposes. Its perceived legitimacy is integrally linked with the rationality and effectiveness of its policies.

To say this is not, however, to say that the Community is a club which members can join or leave at will. On the contrary, the genius of the Monnet method was to assign responsibility for the common policies to a set of institutions which, as a result of their supranational character, could and did acquire an autonomy of their own, which not only enabled them to perform the precise tasks assigned to them, but endowed them with a magnetic character, both with regard to new tasks which were subsequently perceived to be best tackled at European level and with regard to other countries outside the Community. Once enmeshed in the magnetic field, member states - even the most powerful of them - have ceased to be free agents in increasingly large areas of activity. Given the magnitude of the *acquis communautaire*, and their place in the law and administration of every member state, secession by any of them, however large, is scarcely conceivable.

There is therefore a built-in momentum in the Community process. Even in the bad years, the Community's powers continued to grow. It would be profoundly mistaken, however, to imagine that integration of the Community is merely or even mainly the result of an automatic-pilot mechanism built into the original design. As President Delors reminded us in his keynote speech at the Conference, the Community has needed periodic reaffirmation of the political commitment of its members, and the redefinition of their goals in response to changing global and domestic circumstances. The decision to launch European Political Cooperation in the early 1970s, or to create the European Monetary System at the end of the decade, were logical moves given the internal character of the Community and its external challenges, but they were not automatic spillovers from the treaties. The Single European Act, which both formalised and clarified the new agenda, is the most significant example of this periodic process. The fundamental question running through the Conference was, therefore, not surprisingly, whether the Single European Act itself could for long remain an adequate basis for Community action.

The answer, unequivocally, was in the negative. Sooner rather than later the European Community should engage in a fresh round of negotiations modifying the Treaty still further and materially advancing the EC on its way to European Union. In the case of Economic and Monetary Union, the authors of the paper were already (rightly) confident that the European Council itself would accept this argument at its meeting in Strasbourg in December. Even here, however, it is striking that the paper injects such a strong note of urgency into the discussion. Stage One, already agreed upon to start in mid-1990, cannot in the view of Thygesen and Gros be more than a rather short transitional period, if the system is not to become unmanageable, and the benefits already bestowed by the EMS itself, not to mention our progress towards an internal market (e.g. capital-market liberalisation) are not to be put in jeopardy. It was the common belief, however, of all those who wrote or made formal speeches at the Conference that the scope of the Treaty revision process over the coming years would have to be considerably wider than Economic and Monetary Union.

The impossibility of standing still was a common theme of almost all the papers. The issues were set out systematically by Jean-Louis Dewost, Head of the Commission's Legal Services, in his statement on the final morning of the conference. The text can be found in Volume II of the conference papers. There have, as he noted, been major improvements in the functioning of the Community as a result of the Single European Act, but the advantages obtained through this negotiation have now almost been exploited to the full. M. Dewost grouped his remarks on the limitations of the present system under three headings: democracy, efficiency and coherence. In all three respects, the present system was wanting. His conclusion was straightforward:

> A moyen terme, la Communauté devra inévitablement reconsidérer son système institutionnel. Jusqu'à présent, nous avons réussi à progresser et à surmonter nos crises grâce à un système original de *fédéralisme technique multi-sectoriel*. Mais ceci n'a pas manqué d'avoir des conséquences tant sur le plan de la cohérence interne que sur celui de la cohérence externe...Ce système est également indirectement la cause du malaise des Parlements nationaux qui se plaignent de l'extension 'rampante' des compétences communautaires (en vertu du principe interne du 'terrain occupé' et de la jurisprudence AETR sur le plan externe).
>
> Le temps n'est-il pas venu de songer à remplacer ce système par un *véritable fédéralisme politique* fondé sur le principe de subsidiarité, et préservant à la fois l'efficacité de la Communauté et la nécessaire autonomie des compétences nationales et régionales?

The European Union: its functions, institutions and composition

The four papers do not address explicitly the systemic issues implied in the title of this section. Their focus was, as has already been noted, functional. It is, however, possible to put together a rough, identikit picture of the European Union implied by the papers and speeches. [1]

In terms of *institutions*, the present architecture, consisting of the Commission, the Council, European Political Cooperation, the Parliament and the Court, is sufficient with one or possibly two exceptions. The first, already anticipated in the Delors Committee report, and discussed at some length by Thygesen and Gros, is the European System of Central Banks. The second possible institutional innovation would be some common defence capacity within the Community framework. The likelihood of this development in the near future was not, however, rated very highly. On the contrary, it was repeatedly stressed in the papers by both Heisenberg and Froment-Meurice/Ludlow that the crucial priority was to review and reform the Community's capacity to conduct common foreign and security policies. If the question of political authority is resolved, the defence issue in the narrow sense of the term can be relatively easily resolved as and when necessary.

The principal focus in the discussion of institutions, therefore, was not on the creation of new ones, but on the redefinition of relations between existing ones. Given the general consensus that a European Union is both desirable and necessary, it is important to emphasise that every contributor took it for granted that nation-states would continue to have an important role to play in the emerging European Community, that the transfer of powers to Community level should be subordinated to the principle of subsidiarity, and that it was highly unlikely that the Community would in the foreseeable future develop a budget remotely comparable in magnitude to the budgets of existing federations.

This does not, however, mean that the Union will be weak: on the contrary, we expect it to be strong internally and externally. But its power will lie principally in:

- its control of a *common currency* and all that that implies.

[1] For further discussion of the systemic issues involved, see Jørgen Mortensen, *Federalism vs Co-ordination: Macroeconomic Policy in the European Community*, CEPS Paper 47 (forthcoming).

- extensive *regulatory powers*, involving as now not only legislation but also *supervision of implementation*.
- increasing dominance in the *external policy sphere*, with the discipline over domestic policy at all levels that this almost automatically entails.
- *common expenditures* which, though limited in size and certainly of no general macro-economic significance, can make a material difference in certain policy areas (e.g. research and development) and certain regions (e.g. the poorer Community countries).
- *priority-setting* in most if not all spheres of government, through the increasing cohesiveness of the European Council/General Affairs Council, which have already acquired and will increasingly acquire a life and logic of their own, independent of separate member states' politics.
- *peer-pressure* on national governments through the Council machinery and reinforced by the 'spillover' implications of policy areas in which the Community has direct legal responsibility.

In summary, there are few aspects of member states' domestic life that will not be increasingly affected by the Community. Member states will, however, to a very large extent remain responsible for the administration of law, even when it is not their own but the Community's, taxation and spending, and a whole host of 'micro' policies, including, it need hardly be said, education and social policy.

The complexity of this Community structure, which will entail the coexistence of extremely powerful institutions at both Community and national level, makes the problem of *democratic control and political accountability* all the more important. All the papers stressed the urgent need to strengthen the role of the European Parliament and increase the political accountability of the Commission. Action at the European level will not, however~~,~~ of itself suffice. As both President Delors and M. Dewost emphasised, there will also need to be a high degree of cooperation between national parliaments and the European Parliament. There are certain precedents in existing federations, but once again we are forced to emphasise that the European Community is *sui generis* and that unique solutions will have to be found to unique problems.

On one other major issue, namely the *composition of the Community*, the formal presentations to the Conference were remarkably similar. There was, to put it mildly, little enthusiasm for further enlargement on any significant scale. The arguments against it were twofold. In the first place, as President Delors argued in his speech, a Community of 24 would, if it were to be governable, necessitate a considerably higher degree of centralisation of authority in Brussels than an EC of the present scale does.

Secondly, as the Froment-Meurice/Ludlow paper argues, we need to consider the European balance. A *stronger* European Community than currently exists is necessary for the sake of European balance. An excessively *strong or large* Community would, however, for quite different reasons be a threat to European stability. The European Community is already a major power whose policies affect the overall balance of power in the international system. A greatly enlarged Community, assuming that it were not diluted in strength as a result of its enlargement, would almost certainly be regarded as a threat by the Soviet Union, which must in one way or another still be kept within the European political system.

In general terms, therefore, both the keynote speech by President Delors and the Froment-Meurice/Ludlow paper envisaged a Community only slightly larger than now (with the addition of East Germany) as a cornerstone of the European political order in which other groups (e.g. EFTA and the Soviet Union) also had important roles to play. These themes obviously require further development and will receive them at the next CEPS Annual Conference, which is scheduled to take place from the evening of November 14th to November 16th 1990.

It only remains for me to thank all those who spoke or wrote for the 1989 conference and to acknowledge with gratitude the financial help that we received from the Haniel Stiftung, NATO and the EC Council secretariat.

Brussels, March 1990

2 Inaugural address to CEPS Sixth Annual Conference

by Jacques Delors, President of the European Commission

Monsieur le Président, Messieurs les Ambassadeurs, Mesdames et Messieurs,

Gouverner l'Europe? L'assemblée annuelle du CEPS a choisi le bon moment pour la bonne question. Alors que l'actualité nous sollicite, alors que l'histoire des peuples paraît s'accélérer, alors que bien des schémas préconçus de l'avenir du continent européen sont à l'épreuve, il est bon d'engager un travail calme et posé, avec le recul que donne le souci de méthode et la rigueur du raisonnement. Tel est l'esprit de vos travaux préparatoires, menés depuis plusieurs mois avec soin, et qui seront détaillés au long de quatre exposés. J'essaierai d'y contribuer en me situant dans cet esprit même: moins en ma qualité de président de l'une des institutions communautaires; davantage en mon nom personnel, sur la base de mon expérience de la dynamique propre à la Communauté Européenne, telle que les spécialistes des sciences politiques nous ont appris à l'évaluer.

Il s'agira d'abord pour moi d'interpréter la dynamique, le mouvement même de l'intégration européenne en train de s'accomplir. Je le ferai en m'attachant à ses deux composantes principales: l'engagement politique pris au travers de la ratification de l'Acte Unique européen, et les conséquences spontanées, autonomes, qui naissent de cet engagement à partir du comportement des acteurs - ce que les spécialistes désignent dans la théorie de l'intégration par 'spillover effect', ou 'effet d'engrenage'. Sur cette base, la question 'comment gouverner l'Europe' peut être posée dans son sens plein: quelle forme d'organisation des pouvoirs, au niveau de l'Europe, peut être utile au regard de l'objectif recherché en commun?

1. Acte Unique européen: la portée d'un engagement politique

Les philosophes qui fondèrent en Europe les disciplines de l'étude de l'ordre international mirent l'accent d'entrée de jeu sur l'importance du droit. Pour le grand juriste hollandais Grotius, père du droit international, le développement des relations entre les pays était, plus encore qu'au plan interne de la nation, soumis à un progrès de droit. Il récusait ainsi à l'avance le caractère exclusif de la théorie des 'monstres froids'.

L'Acte Unique européen, approuvé par les chefs d'état et de gouvernement à Luxembourg en décembre 1985, ratifié 18 mois plus tard par les douze parlements nationaux, se situe dans cette ligne de pensée. Nouveau traité de la Communauté, il consacre à nouveau le principe fondamental d'un engagement mutuel entre les douze, fondé sur l'égalité en droit des nations contractantes. Parce qu'il lie les états signataires, la portée de cet engagement doit d'abord être pleinement mesurée, quant à l'objectif, aux principes et à la méthode dès lors que l'on veut examiner la question: comment gouverner l'Europe?

L'objectif d'abord. Il est politique. C'est celui de l'Union Européenne, telle qu'elle est évoquée d'entrée de jeu par les pères de la Communauté, puis réaffirmée solennellement dans le préambule de l'Acte Unique. Et lorsque celui-ci désigne l'objectif de 1992 comme étant la réalisation d'un espace économique et social commun, il établit en quelque sorte une des fondations du futur ensemble politique. Au surplus, l'inclusion, au sein du même Acte, de la Coopération Politique intergouvernementale et des dispositions propres à l'accomplissement de l'espace économique et social sans frontières, est un autre signe majeur de la volonté des douze de donner à leur engagement initial une portée qui dépasse le champ de l'économique. Désormais, le processus très large de la Coopération Politique se trouve, en vertu du titre III de l'Acte Unique, articulé explicitement avec celui de l'intégration économique. La Communauté Européenne et la Coopération Politique ont désormais pour objet de contribuer ensemble à faire progresser concrètement l'Union Européenne.

Je me permettrai ici d'ouvrir une rapide parenthèse. N'a-t-on pas assisté, à Paris, ce samedi 11 novembre 1989, lors de la rencontre informelle du Conseil Européen, à une application exemplaire de cette articulation nouvelle? Les chefs d'état ont construit, sous l'ombrelle de la Coopération Politique, les bases d'une analyse et des principes d'action communs à l'egard de la situation des pays d'Europe de l'Est. En cohérence avec cette analyse, agissant en tant que Conseil Européen de la Communauté, ils ont donné l'impulsion nécessaire au lancement de plusieurs initiatives concrètes en matière économique, financière et sociale.

En souscrivant à l'Acte Unique européen, les douze n'ont pas seulement confirmé solennellement la visée finale de l'Union Européenne; ils ont aussi souscrit à des principes d'organisation, à un modus operandi qui renouvelle la force institutionnelle du traité. Pour certains observateurs ce renouvellement n'est qu'un retour aux sources. C'est ce qui apparaît lors des travaux du colloque organisé par les amis de Jean Monnet l'an dernier.[1] Selon ces travaux, le premier traité

[1] Actes du colloque organisé par la Commission Européenne à l'occasion du centenaire de la naissance de Jean Monnet. (Interventions de François Duchêne et d'Emile Noël).

de la Communauté Européenne du Charbon et de l'Acier contenait déjà l'essentiel des principes du gouvernement communautaire qui inspirent l'Acte Unique - une filiation politique qui se lit dans trois caractères communs aux deux traités:

1) *l'importance donnée à la désignation d'objectifs bien définis pour la marche de la Communauté*. En ce sens, on peut parler de l'Acte Unique comme d'un traité-loi avec des objectifs précis, et non d'un traité-cadre à l'image du Traité de Rome;

2) *la confirmation des possibilités d'action de la Commission Européenne dans ses fonctions d'application des décisions prises par le Conseil des Ministres*;

3) enfin, *la synergie entre les trois institutions majeures de la Communauté* est peut-être l'élément le plus singulier et le plus positif du gouvernement communautaire actuel. Ainsi la dynamique communautaire peut-elle à nouveau fonctionner sur la base d'un tryptique indispensable: mieux décider; agir plus efficacement; et démocratiser le processus de décision et de contrôle.

Enfin, s'inspirant de la méthode et non plus seulement des principes du Traité de la CECA, les douze se sont engagés, au travers de l'Acte Unique européen, à faire de la Communauté beaucoup plus qu'une simple zone de libre échange. Si la suppression des multiples obstacles aux échanges à l'intérieur de la Communauté constitue le premier pilier de l'Acte Unique (notamment au travers des dispositions des articles 8a et 100a), celui-ci ne peut être dissocié des cinq autres objectifs qui lui sont, au sens fort du mot politique, indissolublement liés: la cohésion économique et sociale; la dimension sociale; la coopération en matière de recherche et de technologie; la coopération monétaire; et les actions communes dans le domaine de l'environnement. Comme le remarque le professeur Roger Morgan, la portée politique du Traité des Communautés s'en trouve significativement transformée.[2] L'esprit et la lettre de l'Acte Unique sont donc animés par l'idée que la libre circulation effective des personnes, des biens, des services et des capitaux dans des économies aussi diversifiées que celles des douze ne saurait s'accomplir par la seule suppression des 'frontières'. Elle nécessite aussi des actions définies et appliquées à l'échelle de la Communauté qui accompagnent, en quelque sorte, le Grand Marché et le transforment en un espace économique et social organisé. C'est le balancement entre l'*intégration négative* et l'*intégra-*

[2] Roger Morgan, 'The institutions of a "would-be" policy.' Colloque *1992 et l'Héritage de l'Histoire*, de l'Institut Universitaire Européen de Florence et de la Commission Européenne, Bruxelles, juillet 1989.

tion positive déjà annoncé par John Pinder. [3]

Ce qui nous intéresse ici, mesdames et messieurs, c'est que l'engagement de l'Acte Unique étant pris, la notion de solidarité communautaire n'est plus une expression de convenance sans portée politique et pratique. Elle s'impose au travers du concept de cohésion économique et sociale auquel le traité consacre désormais un titre complet. Elle reçoit, en février 1988, par décision du Conseil Européen, les moyens nécessaires à son exécution sous la forme d'un doublement en termes réels des fonds structurels de la Communauté, à l'horizon de 1993. La Communauté s'est dotée, au terme d'un compromis politique dynamique, de l'instrument opérationnel et financier à la hauteur des ambitions affichées par l'Acte Unique.

2. La théorie de l'effet de 'spillover' revisitée

L'existence d'un engagement politique fort des douze états membres de la Communauté, au travers de l'Acte Unique européen, ne suffit pas pour rendre compte de sa dynamique actuelle. Il faut y adjoindre ce que Ernst Haas, père de la théorie néo-fonctionnaliste, désignait sous le nom d'effet de spillover, résultant, selon sa définition, des 'concessions mutuelles entre une multiple variété de secteurs d'activités'. [4] Par 'spillover effect', il faut entendre cette propriété endogène d'une union économique de se perfectionner avec le temps. Au fur et à mesure que se développent les échanges, la libéralisation appelle une harmonisation dont le respect nécessite une constante surveillance. Et aussi des coopérations sans lesquelles il ne serait pas possible de tirer tous les avantages du grand espace économique commun. Doivent également se renforcer les règles de concurrence ainsi que les politiques destinées à prévenir les situations de déséquilibre social ou macro-économique, à pallier la perte d'influence des actions menées au seul niveau national; cette perte d'influence étant due - il n'est pas inutile de le rappeler - à l'interdépendance croissante des phénomènes économiques et à la montée en puissance d'autres nations ou d'autres blocs économiques.

Précisément, l'une des interrogations des politologues concernant le mouvement de la Communauté Européenne au cours des années 70, et jusqu'en 1984, portait sur l'absence ou la faiblesse du mécanisme de spillover. En effet, la principale manifestation probante d'un effet de spillover au cours des années 70 a

[3] John Pinder, 'Positive and negative integration: some problems of economic union in the EEC', *The World Today* 24 (3), March 1968.

[4] Ernst Haas, *In a New Europe?*, Boston, 1964.

consisté dans l'instauration des règles du Système Monétaire Européen en 1978. Encore ces règles n'ont-elles pu être adoptées qu'en dehors du cadre communautaire proprement dit.

Pour Robert Keohane et Stanley Hoffmann, deux chercheurs du Center for European Studies de l'université de Harvard, l'effet de spillover existe bel et bien, mais sa théorie mérite d'être revisitée. Selon ces chercheurs, le déclenchement des mécanismes de spillover n'est pas automatique. Il est subordonné à la confirmation périodique, par les partenaires de l'Union, de leurs objectifs communs et à l'actualisation des engagements fondamentaux qui en découlent - ce qu'ils désignent sous le nom de théorie neo-réaliste. [5]

Au sens de cette théorie, l'Acte Unique ne doit pas être seulement considéré comme l'acte d'aboutissement d'une négociation sur un nouveau contrat de mariage entre les douze. Il aura servi aussi d'initiateur à un ensemble de mouvements qui, en retour, élargissent la capacité d'agir et de s'exprimer en commun. D'où le sentiment d'une accélération, en quelques années, de l'intégration communautaire. D'où aussi la question pratique de la responsabilité et des pouvoirs du gouvernement de la Communauté, illustrée par quelques exemples.

En juillet 1986, les douze s'accordent sur un programme complet de libération des mouvements de capitaux. Un an plus tard, ils décident que la dernière étape de ce programme sera accomplie, pour huit d'entre eux, dès le 1er juillet 1990. Il est remarquable de constater que ces décisions ont été prises pour le seul mérite de la libre circulation des capitaux, sans aucune condition préalable exprimée en termes politiques. Mais en pratique, pour assurer le bon fonctionnement du marché financier européen ainsi instauré, les douze devront resserrer leurs liens dans trois domaines: la coopération des administrations fiscales chargées de contrôler les abus ou les fraudes; l'harmonisation de la fiscalité directe assise sur les bénéfices des entreprises, et au travers d'elle, les politiques d'incitation à l'investissement et à la recherche: enfin, la définition d'un corpus de règles prudentielles, commun aux diverses autorités monétaires chargées de la surveillance des opérateurs, afin de garantir une concurrence équitable et d'assurer un haut niveau de protection à l'épargne investie en Europe. Ainsi doit-on parler désormais non plus seulement d'un marché financier européen, mais d'un véritable espace financier, doté de ses règles de fonctionnement propres.

De même, une coordination monétaire renforcée à l'échelle de la Communauté Européenne s'inscrit dans le prolongement naturel de l'espace financier européen, comme l'illustrent les travaux du professeur Thygesen. Sa mise en

[5] Robert Keohane and Stanley Hoffman, *European Integration and Neo-Functional Theory: Community Policy and Institutional Change*, Harvard, 1989.

oeuvre ne relève pas cependant de l'effet de spillover: elle n'est pas strictement nécessaire à l'accomplissement de la libération des mouvements de capitaux. Le dynamisme économique et la cohérence politique supplémentaires qui en découleront pour la Communauté en font cependant l'enjeu d'une de ces 'confirmations globales' que j'évoquais à l'instant.

Le domaine social est un autre exemple d'application de l'effet de spillover, alors même que les bases juridiques de l'Acte Unique n'ont ici qu'une portée relativement modeste. En raison même des nécessités créees par la libre-circulation, une politique sociale de la Communauté s'élabore, trop lentement aux yeux de certains, mais prouvant son efficacité et sa complémentarité au regard des dispositions nationales. Dès 1986, la directive-cadre sur la libre-circulation des machines comportait une liste d'exigences essentielles en matière de sécurité pour les travailleurs qui sert desormais de référence aux normes professionnelles dans l'ensemble de la Communauté; et depuis 1987, les partenaires sociaux, le Conseil et le Parlement Européen sont consultés sur un projet de statut de société anonyme européenne. Destiné en premier lieu à faciliter la coopération des entreprises au niveau du Grand Marché, ce projet comporte ipso-facto des dispositions relatives à l'information et à la consultation des salariés, inspirées des exemples en vigueur dans les législations nationales, plusieurs options étant offertes pour respecter les principes de subsidiarité et de diversité.

Enfin, l'exemple de la télévision sans frontières est trop connu pour que je ne l'évoque pas ici comme illustration actuelle de l'effet de spillover. Dès les premiers temps de l'élaboration de cette directive, il est apparu clair à Lord Cockfield que la libre circulation des images sur un réseau européen de télévision n'engageait pas seulement des choix communs de technologie et de normes. Elle appelait aussi une vision commune de l'industrie audiovisuelle européenne. Elle mettait en question les moyens à prendre par les douze pour favoriser son développement, face à une concurrence mondiale beaucoup plus apte à bénéficier de l'effet de dimension en Europe. Inévitablement, la question de l'importance à donner au développement, par l'audiovisuel, des cultures qui font la singularité européenne était posée. Car tel est bien, en définitive, le véritable choix politique qui renvoie à notre quête d'identité et à notre besoin d'expression en tant que peuples et en tant que nations.

Ces quelques exemples suffisent à nous montrer à la fois l'importance et les limites de l'effet de spillover. Sa portée effective est en réalité soumise à la vérification periodique de l'engagement mutuel à se diriger vers l'objectif commun. Nous verrons, en nous interrogeant sur les vertus nécessaires du gouvernement de l'Europe, que le mécanisme de l'engrenage doit être prévu et encadré.

3. Quelles hypothèses pour l'avenir?

Pour les politologues qui nous observent, le secret du triangle institutionnel original qui gouverne aujourd'hui la Communauté des douze tient dans sa capacité à gérer cette dialectique: d'un côté, la force des engagements fondamentaux; de l'autre, le développement spontané des multiples effets d'engrenage. Mais peut-on davantage encore approfondir ce secret? Peut-on dire les vertus politiques qui ont permis jusqu'à présent à ce triangle institutionnel de maîtriser le changement, vertus qu'il devra développer, en toute hypothèse, pour faire face aux nouvelles étapes? Ici encore, en me rapportant aux travaux des spécialistes, je mettrai en relief cinq conditions critiques pour satisfaire à l'impératif incontournable: comment gouverner utilement la Communauté?

En premier lieu, *la prise en charge complète, ce qui veut dire sans excès ni défaut, de la nécessité où se trouve la Communauté de faire face, avec succès, aux défis internes comme aux défis externes*: d'où une exigence continuelle d'adaptation, dont les événements en cours dans les pays de l'Est fournissent une éclatante illustration.

En second lieu, *l'identification claire des actions complémentaires qui découlent de la réponse à cette question*. La complémentarité des objectifs principaux et secondaires de la Communauté, entre l'initiative communautaire et celle des états-membres, a pour objet de rendre clair, transparent en quelque sorte, le processus de l'engrenage. Ainsi la politique commune de la recherche a-t-elle été approuvée, par les chefs d'état et de gouvernement, dans le cadre de l'Acte Unique: elle apparaissait à la fois complémentaire de leurs initiatives nationales et propres à accélérer - par sa synergie propre - la modernisation de certains secteurs d'activité confrontés à une compétition farouche.

En troisième lieu, *le respect des diversités*, qui n'est pas simple tolérance passive des différences, mais reconnaissance active de la multiplicité des usages, traditions, systèmes d'organisation propres aux divers pôles nationaux ou régionaux qui composent le réseau interactif de la Communauté. C'est une source d'échanges et de synergies au bénéfice de l'ensemble. Comme l'a montré Helen Wallace, c'est en usant des multiples ressources de la différenciation positive inscrites dans l'Acte Unique que le processus de libéralisation-harmonisation a pu se dérouler aussi rapidement depuis trois ans, sans qu'aucun des objectifs majeurs du livre blanc ait dû être abandonné. [6]

De même - mais j'ose à peine l'évoquer, tant il risque d'être galvaudé - *le principe fondamental de la subsidiarité doit désormais réguler la répartition des res-*

[6] Helen Wallace, 'Making multilateralism work: negotiations in the European Community', London, Royal Institute of International Affairs, août 1988.

ponsabilités entre les différents niveaux de pouvoir, communautaire, national et régional, dans la Communauté. Ceci mérite que l'on s'y arrête quelques instants.

Rappelons que dans tout système d'inspiration fédérale, tel que la Communauté Européenne, le principe de subsidiarité apporte un contre-poids permanent aux mécanismes de spillover qui tendent, dans un monde complexe, à charger excessivement l'échelon du pouvoir central. Celui-ci, d'après le principe de subsidiarité, n'est fondé à assumer une compétence que si celle-ci ne peut être exercée avec la même efficacité aux échelons décentralisés. On imagine aisément l'importance de ce principe aux yeux des états membres de la Communauté qui acceptent, par elle, la nécessité d'un exercice en commun de la souveraineté: a fortiori pour ceux d'entre eux qui appliquent déjà ce principe pour leur propre compte, dans le cadre d'une répartition décentralisée des pouvoirs.

Mon opinion est que le principe de subsidiarité est appelé à jouer, quelles que soient les hypothèses de travail, un rôle nouveau et primordial dans l'organisation du gouvernement de la Communauté. Au point qu'il deviendra nécessaire d'en préciser les principes et les modalités dans tout nouveau traité. Il serait, par exemple, aisé de montrer l'utilité de telles dispositions pour la définition et la mise en oeuvre de l'Union Economique et Monétaire.

Enfin, dans le même esprit, *tout nouveau traité devrait accomplir un progrès en vue d'améliorer le processus de décision et de combler ce qu'il est convenu d'appeler 'déficit démocratique' de la Communauté*. Les exigences seront encore plus fortes lorsqu'il s'agira de mettre en oeuvre l'Union Economique et Monétaire. Dès maintenant, il importe d'associer davantage les parlements nationaux aux processus de la construction européenne.

Telle est la grille d'analyse que je vous propose pour traiter les problèmes politiques et institutionnels de demain. Quelle sera l'étendue du domaine de compétence de la Communauté? Quelle sera l'ampleur de ses responsabilités au regard des états dont elle recevra délégation de pouvoirs? Pour approfondir les réponses à ces deux questions, on ne peut échapper au choix d'hypothèses théoriques de travail. Celles-ci portent sur les objectifs que l'on s'assigne et sur l'étendue de la Communauté.

On supposera d'abord, car il faut une base claire au raisonnement, que la Communauté à douze est parvenue à accomplir l'objectif de l'Acte Unique: un espace économique et social sans frontières en 1993. Dès lors, deux hypothèses sont à considérer.

Dans un premier cas, on suppose que les douze consentent seuls à assumer l'objectif de l'Union Européenne dans sa plénitude. Cette hypothèse n'exclut pas, au contraire, que les autres états d'Europe veuillent établir entre eux et avec la Communauté des relations étroites et d'un type nouveau. Nous en testons la possibilité dans nos discussions présentes avec les pays de l'AELE.

Dans une seconde hypothèse, l'objectif de l'Union Européenne est partagé par un nombre beaucoup plus important d'états-nations européens. Leur appartenance simultanée à la même Communauté Européenne résout alors de manière radicale la question de leurs relations: elle signifie en effet que tous ces états partagent avec les douze les disciplines communes de la politique économique et sociale, de la politique commerciale et de la coopération politique.

Comment dès lors concevoir un gouvernement de l'Europe utile, approprié à la réalisation des objectifs communs ou partiels? Il me semble personnellement que les caractéristiques du gouvernement de l'Europe correspondant à ces deux hypothèses de référence sont fort différentes. Dans le premier cas, celui de la Communauté à douze, le défi demeure d'incorporer à la Communauté la dimension de sa sécurité dans ses trois aspects: économique, militaire et idéologique. Parallèlement, la relation entre la Communauté et les autres états d'Europe s'approfondirait sous l'égide d'une coopération pluridimensionnelle et aux modalités adaptées aux diverses situations. Si l'on envisage à l'inverse la seconde hypothèse, il apparaît que l'enjeu majeur d'un gouvernement de la Communauté élargie à la plus grande partie de l'Europe sera de disposer d'une capacité de décision et d'arbitrage propre à assurer l'efficacité du nouvel ensemble.

La théorie comme la pratique justifient ce raisonnement. La théorie des unions politiques nous rappelle que l'augmentation du nombre des pays participants n'est possible qu'au prix d'un accroissement de la capacité de décision au niveau central, faute de quoi la complexité des règles de concertation - destinées à préserver les intérêts des nations composantes - condamne à la paralysie. Par ce raisonnement, Stanley Hoffmann et Robert Keohane soutenaient déjà que les adhésions de la Grèce, de l'Espagne et du Portugal impliquaient par elles-mêmes un renforcement du processus décisionnel de la Communauté, même en l'absence de l'objectif de 1992. Ce qui fut fait dans l'Acte Unique.

La théorie des jeux en second lieu nous enseigne que le risque de coalitions partielles visant à optimiser les gains d'une coalition minoritaire s'accroissent avec le nombre de participants au jeu. L'Ambassadeur de Schouteete a démontré que jusqu'à présent, les mécanismes institutionnels de la Communauté à six, puis à douze, avaient empêché la constitution de coalitions visant à bloquer son fonctionnement. En serait-il de même dans un groupe deux fois plus nombreux? On ne peut l'assurer, à moins d'accroître le degré de supra-nationalité de l'ensemble.

Enfin, la pratique de la Communauté montre que la gestion de la diversité n'est supportable que si les règles d'exception ne concernent qu'une minorité de participants. C'est ainsi qu'ont pu être gérés sans trop de difficultés les processus de transition ménageant l'entrée progressive des nouveaux arrivants: ou encore la participation incomplète des états membres de la Communauté à l'accord de change du SME. Mais qu'en serait-il si un nombre significatif d'états devait bénéficier d'exceptions par ailleurs plus nombreuses? Les tensions à l'intérieur de la Communauté liées a l'inégalité des engagements ne pourraient être supportées que par une hiérarchisation de la participation aux processus décisionnels. Une telle hiérarchisation suppose encore une fois, au sommet de la pyramide communautaire, un exécutif doté de pouvoirs suffisants, mais démocratiquement responsable.

La marche vers l'Union Européenne dans une Communauté sensiblement plus nombreuse qu'elle ne l'est aujourd'hui n'est nullement inconcevable. Elle serait seulement plus difficile et sans doute plus lente. Plus difficile, car les modalités d'exercice de la subsidiarité devraient s'accommoder d'une délégation de plus en plus importante au profit de l'échelon central, afin de lui permettre de gérer la complexité et de faire échec aux coalitions. Plus lente, car l'énergie politique devrait dans un premier temps être consacrée à l'affermissement de l'échelon central, en vue d'obtenir une convergence effective de l'ensemble de la Communauté sur les objectifs intermédiaires, d'ordre économique et social.

On peut certes considérer des variantes à cette seconde hypothèse, comportant une progression à plusieurs vitesses pour des sous-groupes différenciés: l'Europe à géometrie variable. Mais sans oublier que toute complexification de la Communauté, par une différenciation des objectifs poursuivis, se traduira inévitablement par un renforcement du centre. Ce dernier, pour être efficace, doit à la fois gérer les objectifs du sous-groupe le plus ambitieux et exécuter les politiques ou les tâches de coordination communes à l'ensemble.

Gouverner, c'est choisir. Pour en revenir à la Communauté à douze, l'extension de ses compétences conduira à poser deux problèmes: celui de l'efficacité de son exécutif - et quel exécutif? - et celui du contrôle démocratique en tenant compte de la coexistence des parlements nationaux et du Parlement Européen.

L'élargissement significatif de la Communauté rendrait encore plus impératif le souci de prescrire un processus de décision efficace, au prix d'une hiérarchie des compétences et de transferts de souveraineté. Il obligerait, de même, si l'on veut maintenir l'esprit communautaire, à inventer des formes originales de contrôle démocratique. Sinon, ce serait la fin de l'idéal défini par les pères de la construction européenne et le retour aux embarras d'une organisation intergouvernementale classique. Il n'est pas trop tôt pour y réfléchir sérieusement, avant même de se lancer dans des prospectives hasardeuses sur le futur de la Grande Europe.

Part II Conference Papers

3 Concrete steps towards monetary union

Daniel Gros and Niels Thygesen

Introduction

This paper was originally prepared for the 6th annual conference of the Centre for European Policy Studies (CEPS) whose general theme was 'Governing Europe'. One part of this general theme is the management of the process of integration in the monetary sphere whose endpoint can be described by the term 'monetary union'. This paper therefore discusses the four main issues that arise on the way towards monetary union, namely:

i) What is the meaning of 'monetary union'?

ii) Would the creation of a monetary union be beneficial on purely economic grounds?

iii) What concrete steps would be needed to establish a monetary union?

iv) What institution would be needed to govern a monetary union?

The present paper concentrates on *monetary* union. It does not discuss in detail the issues that arise from setting up an *economic* union, a term which is more difficult to define with precision. This does not imply that economic union, however defined, is less important; rather it reflects the conviction of the authors that the 1992 programme *per se* will already lead to a degree of integration that would be close to an economic union, at least in the most widely accepted sense of 'a unified market in goods, services and factors of production'. With the exception of the coordination of budgetary policies it therefore does not discuss other non-monetary policies, such as regional, structural and competition policies, which would be part of economic union.

The paper discusses the four issues mentioned above in turn. It starts with a discussion of the meaning of monetary union. This discussion suggests that a system of 'irrevocably-fixed' exchange rates (plus capital mobility, which is the definition of a monetary union most widely used) would not yield all the benefits, and indeed would incur most of the costs, to be expected from a full monetary union with a common currency. Moreover, one could argue that a monetary union consisting 'only' of fixed exchange rates would not necessarily require, from a strictly economic point of view, the establishment of a new common monetary institution, as long as currency substitution is limited, whereas a common currency would, of course, have to be managed by a common monetary institution.

Section 2 of Part One discusses the economic costs and benefits of irrevocably-fixed exchange rates. Section 3 then discusses the additional benefits of creating a full monetary union in the sense used henceforth in this paper, namely the establishment of a common currency. These sections argue that the main cost of fixing exchange rates would be the definitive loss of the exchange rate as a policy instrument. This cost, however, may be more than offset by benefits in the form of the substantial savings in terms of transactions costs and greater market transparency that would result from the use of a common currency.

Section 4 discusses the relationship between economic and monetary union. It argues that the 1992 programme contains most of the elements of an economic union. This section also discusses to what extent the formation of a monetary union requires binding guidelines to be imposed on national budgetary policies and proposes some preliminary ideas as to how they might be implemented.

Section 5 discusses briefly the economic requirements in terms of convergence of inflation and fiscal policy a country needs to fulfil before it should participate in a monetary union. These criteria are then applied to the countries (Greece, Spain, Portugal and the UK) that do not at present participate in the EMS with narrow margins.

The main part of the paper comes in Part Two, which discusses concrete steps towards the establishment of a monetary union based on the three stages proposed in the Delors Report.

Before discussing the institutional steps proposed by the Report, section 1 of Part II also analyses in some detail possible alternatives to institutional steps, namely the so-called parallel currency or competing currencies approach. A detailed discussion of this issue is useful because the UK government has put forward ideas along the latter line. This essay takes the position that it would not be possible to advance along this route. Transaction costs and externalities make it highly unlikely that the market will on its own adopt a common currency, even if all currencies (or only the écu) were made legal tender throughout the Community - a step which would be practically impossible to implement in any meaningful sense before the irrevocable fixing of exchange rates.

Section 2 of Part II then discusses the three stages of the Delors Report. Stage one would consist of a strengthening of the EMS and full participation by all EC currencies. Some non-institutional steps in this stage would be needed at the same

time as the remaining capital controls are abolished in France and Italy in 1990. It is argued that stage one should not last too long because the scope for genuine *ex ante* collaboration of monetary policy is limited, especially for the major EMS central banks. Purely voluntary cooperation in a state of full capital mobility could prove to imply instability and policy conflicts.

The second stage appears to present the most interesting and challenging analytical problems because it would represent an intermediate position between two systems the economics of which have been extensively researched, namely the fixed-but-adjustable peg system with full capital mobility of stage one and the monetary union of stage three. The various ways to organise monetary policy in this transition phase are therefore discussed in some detail.

Stage two would begin with the creation of the European System of Central Banks (ESCB) which would have to formulate and implement the common monetary policy stance of the system. It would imply a qualitative shift relative to the present EMS, ideally in all three of the directions referred to in the Delors Report and in papers submitted to it by individual members, i.e. pooling of (i) central bank operations, (ii) important instruments of external and domestic monetary policy, and (iii) authority for jointly formulating guidelines for policy.

The description of stage three is very brief because once a full monetary union had been attained national central banks would disappear or become mere regional components of the ESCB, which would then formulate and implement the common monetary policy like any central bank in a large federated country.*

(*) In a paper of this length, treatment of the issues raised is necessarily limited. We plan to develop them in our forthcoming book, *European Monetary Integration: Moving from the EMS to Monetary Union*.

Part I
Economic costs and benefits of monetary union

1. The meaning of monetary union

The Delors Committee defined a monetary union as 'a currency area in which policies are managed jointly with a view to attaining common macroeconomic objectives'. [1] However, for most non-economists the meaning of 'monetary union' might be more straightforward. A European monetary union would mean a common currency. This is somewhat in contrast to the view of the Delors Committee (and that of the 1970 Werner plan) for which a common currency was not essential: indeed, for the Delors Report the principal features of a monetary union were: [2]

i) the complete liberalisation of capital transactions and full integration of banking and other financial markets; and

ii) the elimination of margins of currency fluctuation and the irrevocable locking of exchange-rate parities.

The Werner plan stated explicitly that this would make national monies perfect substitutes and therefore be equivalent to the creation of a common currency. A similar view seems to underlie the Delors Report, but is not made explicit. The purpose of this section is to show that a system of irrevocably-fixed exchange rates would behave differently from a full monetary union with a common currency. [3] This does not imply that a monetary union *without* a common currency can coexist with more than one monetary policy. From a macroeconomic point of view it is clear that a system of fixed exchange rates (and full capital mobility) implies that there is only one system-wide monetary policy. The arguments of this section will concentrate on the microeconomic implications, or the 'fine print' of the notion 'monetary union' which has potentially important implications.

National monies would become perfect substitutes if they were equally convenient for the three classical functions of money, namely: unit of account, store of value and transaction medium. The remainder of this section shows in some detail why even in a system of irrevocably-fixed exchange rates national monies would fulfil these functions to a different degree for most economic agents.

[1] Committee for the Study of Economic and Monetary Union, 'Report on economic and monetary union in the European Community', para. 22. (It is perhaps not surprising that a Committee composed mainly of central bankers should adopt such a policy-orientated definition.)

[2] *Ibid.* An additional feature mentioned was 'the assurance of total and irreversible convertibility of currencies'. However, convertibility has not been an issue since the early 1960s when the remaining restrictions of the post-war period were eliminated.

[3] The remainder of this section draws heavily on Gros (1989d).

Unit of account

As long as national monies persist, prices in the retail trade will presumably continue to be quoted in national currency. Consumers who are used to thinking of and comparing prices in one national currency will find it inconvenient to translate prices quoted in one currency into another at any exchange rate, if this is not a convenient round number. For consumers in, e.g. West Germany, the Italian lira would therefore not be a perfect substitute for the German mark as a unit of account. The difficulty of adopting even very simple changes in the unit of account is illustrated by the French experience of taking two zeros off the French franc in 1958. Thirty years later some people continue to use the 'old' franc as a unit of account. Given the much more complicated matrix of exchange rates a European monetary union would see these difficulties magnified at the European level.

Store of value

Different national currencies would be perfect substitutes as stores of value if interest rates were perfectly equalised across currencies. However, this is not certain to happen. As long as national currencies continue to exist, exchange-rate changes can never be ruled out even if rates are supposed to be irrevocably-fixed. The credibility of the exchange-rate commitment will therefore determine the degree to which interest rates are equalised across national currencies.

The potential for interest differentials that remains, even in an environment of fixed exchange rates and free capital mobility, can be illustrated by the interest-rate differentials between the Dutch guilder and the German mark. Over the six years from 1983 to 1989 the Dutch guilder depreciated by a total of only one-half percent against the German mark; moreover, the exchange rate has never moved outside a corridor less than 1 % wide. The Dutch guilder has therefore behaved as if the allowed band of fluctuations had been less than 0.5 %. This might be considered a good approximate of a monetary union between these two countries. However, despite the absence of capital controls, short-term Dutch guilder interest rates have been on average almost 100 basic points higher than German mark interest rates. [4]

[4] This is true for assets with exactly the same risk characteristics, since the two interest rates compared here are 3-month Euro rates. It is also interesting to note that, despite the existence of the Belgium-Luxembourg Economic Union, an exchange-rate guarantee for the Belgian-Luxembourg-Franc exchange rate costs about 25 basis points.

In the absence of complete interest-rate equalisation, for example because of some doubts about the irrevocable nature of exchange-rate commitments, national currencies would therefore not become perfect substitutes as a store of value.

Transaction medium

This is the most important barrier to making national currencies perfect substitutes, even with irrevocably-fixed exchange rates. For a person doing his shopping in Germany the Italian lira will not be a perfect substitute for marks if he has to exchange them for marks prior to every transaction. Exchanging currency involves a cost in the form of the bid-ask spread, which would continue to exist since financial institutions would still have to use them (or foreign exchange commissions) to cover the costs they incur by holding bank notes in different currencies and having to set up several accounting systems. This cost is not negligible; it varies with the size of the transaction. For cash it might be as high as 2-3 %.[5] This is true even for very stable exchange rates, such as the mark-guilder. Market size seems to be a more important determinant of the spread, since in most European countries the spread on the US dollar is lower than on other European currencies. This implies that fixing exchange rates is unlikely to reduce these costs from their present high level.

These large costs of exchanging cash would probably deter individuals from using more than one currency at once for everyday retail transactions. The Dutch case is again a useful example since, even with the very low exchange-rate variability and the large degree of commercial and financial integration between the Netherlands and West Germany, there is no indication that a significant process of currency substitution has taken place in the Netherlands so far.

One might argue that these difficulties might be overcome if all national currencies became legal tender throughout the Community in a generalised process of mutual recognition. However, as will be argued more extensively below (see Part II, section 1, i, on the parallel currency issue), this would be difficult to organise as long as exchange rates were not completely fixed and bid-ask spreads had not been eliminated. The basic problem is that if exchange rates are fixed for legal tender purposes, but market exchange rates are not, Gresham's law would operate very quickly and 'bad' money would drive out 'good'.

One might also argue that there are examples of fixed exchange-rate systems in which national currencies appear to have become near-perfect substitutes, such as the Belgium-Luxembourg exchange-rate union and the linkage of the Panamanian currency to the US dollar (also 1:1). However, in these, as in other similar systems, there is always one currency that completely dominates the other, smaller one, which is used only locally; moreover, the union (however unequal) consists of only two currencies, and not of the dozen that would subsist in Europe. These existing examples of monetary unions are therefore not a useful guide to what would happen after the irrevocable fixing of exchange rates in Europe.[6]

[5] For inter-bank transactions the bid-ask spread is usually much lower, between most major currencies it is about 0.05 - 0.1 %. For the corporate sector different national currencies (and the ecu) might therefore more easily become very good substitutes. However, most transactions balances are held by households.

For all these reasons it is unlikely that the fixing (even if it is supposed to be irrevocable) of exchange rates in Europe will make national monies perfect substitutes. Does this matter? Yes, because it has two consequences which are economically and politically important.

First, as long as national monies remain imperfect substitutes national money demands will remain stable. This implies that there is no economically compelling reason to create a common monetary institution. As long as there is agreement as to which national central bank is the leader, the system could work much like the present EMS: the leader, or anchor, national central bank would set its monetary stance (presumably geared to the objective of price stability, if it is the Bundesbank) and the other national central banks would just react. The stance of the leading national central bank would then be transmitted through the foreign exchange markets to the entire system.[7] The degree to which national currencies become substitutes has therefore important implications for the economic arguments for a European central bank.

Second, most of the benefits from a monetary union will come from savings in transaction costs. This is discussed in more detail in section 3, which discusses the benefits of going from a system of irrevocably-fixed exchange rates to a common currency. The main benefit is the full elimination of transaction costs and therefore more definitive attainment of the potential gains from specialisation and competition, particularly in financial markets.

It is evident from the nature of these benefits that they could at best be only partially obtained in a system of irrevocably-fixed exchange rates. Furthermore, the main cost associated with a monetary union, namely the loss of the exchange rate as a policy instrument, would arise even in a fixed exchange-rate system.

A system of irrevocably-fixed exchange rates might therefore yield few of the economic benefits of a monetary union and incur most of the costs. This suggests

[6] A further complication, in relative difference to most existing monetary unions, is that the exchange rate is usually equal to one, which eliminates inconvenient computations.

[7] See Gros (1988a) for a further elaboration of this idea.

that the really worthwhile target is not the locking of parities, but the creation of a common currency. This result lends strong support to the call in the Delors Report that "the replacement of national currencies by a single currency should ... take place as soon as possible after the locking of parities.' [8]

2. Irrevocably-fixed exchange rates: costs and benefits

In the present EMS, and in the two transitory stages towards EMU envisaged in the Delors Report, realignments of central rates may still occur, though the trend towards infrequent and limited recourse to them observable in the EMS since 1983 is expected to persist. What are the costs and benefits to a country of formally renouncing future use of realignments between participating currencies, as would be required at the beginning of the final stage of EMU? [9] For the sake of clarity we have divided our discussion of this issue into two subsections. The first deals with the general issues raised by the traditional literature of the optimum currency area and the credibility issue raised by more recent literature on incentives for policy-makers to behave in a time-consistent manner. The second deals with a number of more specific issues often raised in more policy-orientated discussions in Europe.

i) General considerations: optimum currency area and time-inconsistency

Traditional macroeconomic theory suggests a general answer to the question of why realignments represent a useful policy option: governments may find realignment desirable, if the economies for which they are held to be responsible to their electorates experience differentiated shocks. [10] The shocks may be external or domestic in origin; a major energy price-hike or a domestic cost-explosion are examples that come readily to mind. Having experienced such a shock, a government would come to regret an earlier commitment to a fixed exchange rate, since accommodation of the shock through realignment may entail lower costs of adjustment than the alternative of much more gradual adjustment of relative national price-levels. If European governments anticipated that important differentiated

[8] Delors Report, para. 23.

[9] Even when realignments are excluded one might envisage a limited flexibility in market exchange rates within narrow fluctuation bands such as in the present EMS. The benefits of eliminating this residual flexibility too are best seen as being of a similar nature to the introduction of a common currency. These benefits are discussed in the following section.

[10] See, for example, the survey by Cohen (1989).

shocks were likely to occur in the future, *regardless of the exchange-rate régime* (and of the gradual progress of integration), they would be taking a serious risk by committing themselves to maintaining irrevocably-fixed exchange rates. The emerging acceptance of EMU as an objective is, above all, an implicit recognition by most EC governments that the likelihood of large and nationally-differentiated shocks is fading.

Even if this recognition is widely shared, governments are correct in perceiving that their ability to conduct active stabilisation policies is constrained by irrevocable fixing of exchange rates. Moreover, modern macroeconomic theory points out that since monetary expansion and devaluation are at their most effective when least expected, the short-term rewards of breaking the fixed exchange-rate commitment could well be seen as rising for a time after the declaration of an intention to keep the rate irrevocably fixed.

This suggests that governments may have or discover incentives to opt out, if they can, in order to pursue macroeconomic objectives. For one major category of shocks to a participating economy - changes in domestic economic policy that make the fixed exchange rate unsustainable - there is clearly no independence of the exchange-rate régime. In EMU policy shocks would be limited to those that do not threaten to upset fixity. Governments that see *a priori* the remaining scope of action as too narrow will perceive a likely cost in joining EMU. Could that cost be offset by benefits?

A government which explicitly wants to retain freedom to realign its exchange rate - or a government whose commitment to fix the rate remains subject to some doubt - pays a price. Agents in the national markets for goods, labour and financial assets will assume that freedom of manoeuvre will occasionally be used. They will tend, in an economy whose currency could become subject to devaluation, to set a more rapid rate of increase of prices and costs and to add a risk premium to the required yield on assets denominated in the national currency. Higher inflationary expectations would raise actual inflation and nominal interest rates. If the exchange rate in fact remains fixed, there will be temporarily higher inflation and lower output than in the situation where the commitment to fixity had been seen as truly irrevocable. If the currency is in fact devalued, the critical perceptions of private economic agents will have been borne out and a non-inflationary reputation will be that much harder to build up in the future. As the EMS experience has shown, markets have a very long memory. The pace with which convergence in inflationary expectations and interest rates takes place will 'depend critically on the extent to which firms, households, labour unions and other economic agents were convinced that the decision to lock exchange rates would not be reversed'. [11]

[1] Delors Report, para. 22.

There is no substitute for the final stage in the process towards EMU - the irrevocable locking of exchange rates - in achieving this convergence.

In general macroeconomic terms the basic cost-benefit assessment of taking this step has to include (1) the cost of giving up the possibility of accommodating differentiated, major and non-transitory shocks, occasionally directly induced by national policy-makers, against (2) the benefit of more definitively strengthening confidence in the long-run predictability and stability of the price level. Obviously the level at which exchange rates are set initially would also have to be regarded as broadly acceptable. The verdict on how the balance between (1) and (2) comes out for any particular participant must necessarily be subjective, since it depends on the likelihood of future shocks and the degree of credibility of political agreements. All that can be said in confidence is that the balance between costs and benefits must have shifted significantly in favour of the latter as the likelihood of differentiated shocks within the EC is reduced while benefits of full convergence of interest rates and of inflationary expectations at a low level have become more clearly perceived.

ii) European policy issues

With the general background of the previous subsection it may be useful to examine some of the more specific arguments advanced for retaining the exchange rate as a policy instrument. They draw largely on the macroeconomic theory of the 1960s and 1970s, on the relative merits of fixed versus flexible exchange rates and on criteria for delimiting optimal currency areas. Though they may all be regarded as variants of the above general principle for deciding upon the exchange-rate régime, they still need to be addressed since they are likely to appear in the national debate on EMU in several of the prospective participating countries. They also tend to place the debate on EMU more squarely in the environment facing the European economies in the 1990s than the very general and ahistorical context of the Delors Report. Realignments of central rates may continue to be seen as necessary on the following, more gradualist, grounds:

(1) to accommodate residual differences in the autonomous elements affecting national inflation rates;

(2) to modify the real exchange rate as part of a current account adjustment;

(3) to accommodate international portfolio shifts that affect participating currencies differentially; and/or

(4) to enable some participants to continue to make use of an inflation tax.

Let us examine these traditional arguments in favour of retaining occasional realignments.

Argument 1: Inflation differentials have narrowed sharply between EMS participants - and between most OECD countries - since the early 1980s. Most notably, disinflationary policies in France and, to a lesser degree, Italy have reduced the rate of increase in unit labour costs to nearly the rates observed in West Germany and the Netherlands. [12] While it was accepted in the early 1980s as an inevitable legacy of the turbulent decade of 1973-82 that inflation rates were likely to remain trend-wise higher in Italy and France than in Germany regardless of major policy efforts to reduce them, and had to be accommodated by occasional and rather sizeable realignments, there is in retrospect today a realisation that observed inflation differentials over the decade were largely the result of divergent policy responses, and of wage indexation in some countries, following the global inflationary boom of the early 1970s and the first oil-price shock. Differences in vulnerability to external price shocks due to different production structures and energy-input requirements, or to the composition of foreign trade, appear to have been much less important than the secondary effects for which policies were largely responsible.

Could the divergence in permissiveness with respect to domestic inflationary mechanism be attributed to different degrees of aversion to inflation or to differences in perception of the attainable unemployment-inflation trade-off? These views, too, have been weakened by the experience of the 1980s. The trade-off turned out to be less unfavourable than expected in the high-inflation countries; and the reduction of inflation has been given higher priority in economic policy in all EMS countries after the absorption of the second oil-price shock. The argument that nominal exchange-rate changes are required to accommodate residual, small but cumulatively important inflation differentials which are largely unavoidable is accordingly of minor significance. The perception of policy-makers in the so-called weaker currency countries, already reluctant in today's EMS to initiate realignments, seems rather to be that the potential use of the policy in-

[12] The arguments here have adopted the perspective of EMS participants with insufficient anti-inflationary credentials. Since EMU aims to be consistent with the best past price behaviour, there should in principle be no cost in terms of higher average inflation for the lead group in price performance. Whether that assumption is likely to prove correct, and what could be done to make its achievement more likely, is discussed in the analysis of stages in Part Two. In any case it could be argued that the risk of revaluations in the strong-currency countries to protect them against importing inflation from their partners also imposes adjustment costs on Germany, the Netherlands etc.; their firms may become less ready to invest and to specialise than in a régime where exchange-rates are irrevocably fixed.

strument of devaluation tends to perpetuate inflation differentials which have little macroeconomic rationale.

Argument 2: Even if national inflation rates were to converge fully, some trend-wise changes in real exchange rates might be required to sustain simultaneous external and internal balance in each participating country. Differences in growth rates of capacity outputs and/or in income elasticities in the foreign trade of participants are potential sources of external and/or internal imbalances in the medium term. If, say, France and Italy need to grow faster than West Germany, for demographic or other reasons, to preserve internal balance, or if the income elasticity in the world demand for German-produced goods is well above those for French- and Italian-produced goods for an extended period, some trend-wise real appreciation of the DM against the other two currencies might be warranted. Vona and Bini-Smaghi (1988) and some of the models of international macroeconomic interaction report evidence of systematic differences in income elasticities in foreign trade within the EC, suggesting that France would face trend-wise deterioration of its trade balance at growth rates of demand parallel to Germany's. Furthermore, differences in labour force growth between on the one hand France, Italy and Spain (which, in addition, currently have relatively high unemployment), and on the other hand Germany suggest that the former three could need to grow faster than Germany.

Are growing trade imbalances sustainable in an EMU where intra-union exchange rates are locked? In a similar vein, could the participants collectively adjust their external position vis-à-vis the United States without some intra-European exchange-rate adjustments, given their very different starting positions? It is, not least, a European view that the US current account deficit will have to be reduced by at least $ 100 billion over a fairly short span of years to make the US deficit sustainable. [13] A substantial part of the counterpart to this adjustment will have to show up as a deterioration of the current accounts of potential EMU participants. Could this large adjustment - even though it may lead only to a small collective deficit by the early to mid-1990s - be made without realignments? If not, should the decision to fix exchange rates irrevocably at least wait for this adjustment to be completed?

There are three reasons for saying that neither the trend-wise arguments on imbalances, nor the more transitory need for adjustment to a reduced US deficit, justifies continued reliance on nominal exchange-rate changes within Europe as an instrument of policy.

The *first*, and most important, argument is that the price elasticities in the foreign trade of European countries - though large enough to meet the minimum conditions for reducing imbalances - appear simply to be too low to be relied upon to bring about a major part of the adjustment. If they were to be used with that purpose in mind, realignments would have to be so large that they would more permanently upset the results of inflationary convergence and monetary cohesion which have been achieved in the EMS since 1983. The bulk of the adjustment will have to come from other policy instruments and from the more indirect impact on imbalances of long-run market-oriented processes. Furthermore, in an EMU, temporarily large external imbalances will be more readily financeable than in a system that relies on regular, though modest, realignments.

The *second* argument is that we do not typically observe persistent trends in real exchange rates between the industrial countries, and in particular, within Western Europe, as the reasoning on relative demand growth and income elasticities would lead us to expect. Indeed, as the work of Krugman (1989) suggests, there is some long-run positive correlation between these two determinants of the trade balance: countries with above-average growth also tend to face high income elasticities in the world demand for their products, creating some automatic offset in the long run between the two. In trade between the potential members of an EMU there are no permanently-acquired comparative advantages; the pattern of specialisation is marked primarily by increasing returns in the production of a limited range of goods. The development of the single market widens the opportunities to share in such gains for firms of any size in countries that have reached comparable levels of industrial development. Reliance on changes in nominal exchange rates is not central to the operation of this process towards long-run equilibrium.

The *third* argument is that changes in price competitiveness are not blocked by locking exchange rates inside the EMU. The experience of some EMS-countries suggest that real effective exchange rates do change to some extent independently of the policy of pegging to other EMS-currencies (see de Grauwe and Vanhaverbecke, 1989). For example, Belgium has improved its competitive position (measured by relative unit labour costs) by approximately 10% in the 1983-89 period while the Belgian franc was broadly stable in the EMS; on the other hand

[13] To eliminate the US current deficit fully, a swing of about US $ 200 billion would actually be required, but a modest deficit may be sustainable. Cline (1989) has, using a model of world trade and macroeconomic interaction, calculated a so-called 'Feasible Adjustment Package', consisting of fiscal tightening in the US, faster growth in Europe, Japan and the East Asian economies, and real depreciation for the dollar differentiated by country, which would achieve an apparently sustainable constellation of current account imbalances. The package envisages substantial intra-European realignments, e.g. a 17 percent devaluation of the French vis-à-vis the DM and even larger adjustments for the Italian lira and for sterling.

the competitiveness of Denmark has deteriorated by 10% over a similar period while a similar nominal exchange rate policy was pursued. Domestic cost and price performance is more important than exchange-rate policy in influencing competitiveness and the major effort has to be directed at that performance.

In summary, the cost of not being able to facilitate real exchange-rate changes through realignments cannot be dismissed as insignificant, but it is smaller than the traditional literature assumes. Furthermore, much of it has already been incurred in the current EMS with gradually diminishing recourse to realignments since 1983. Broadly, the present distribution of economic activity has been accepted; otherwise it would have been reckless of the EC to adopt its 1992 programme and for the eight countries who have been in the EMS since 1979 to have managed the system as they have done. Small and infrequent realignments will continue to be possible in stages one and two envisaged in the Delors Report, but they will not in themselves bring about major adjustment - at best they may moderately facilitate it. Advocates of such realignments have to bear in mind, however, that the more they are resorted to, the more necessary it may become to make it clear that the participating countries do aim to create an area of fully fixed exchange rates in the future. Otherwise realignments will lose even their limited capacity to affect real exchange rates.

Argument 3: Portfolio shocks may occur which affect national currencies differentially, because the latter do not have a similar degree of international acceptability. Initially in the EMS the role of the DM as the only internationally-used currency in the system was seen as justifying occasional realignments, as the global demand for DM assets grew faster than the demand for other currencies. Historically portfolio shifts out of the dollar on several occasions determined the timing of EMS realignments. This historical asymmetry, though clearly weakening with time, as financial markets developed fast outside Germany, capital controls were removed and economic convergence improved, has persisted in a mild form (see Giavazzi and Giovannini, 1989). It may intensify, if sterling, historically more linked to short-term movements in the dollar than other European currencies, joins the EMS, though the 1987-88 experience of 'shadowing' the DM suggests that such historical correlations can be broken even by informal and unilateral decisions.

Locking exchange rates permanently would bring benefits rather than costs in this respect. In an EMU assets denominated in the participating currencies would become much closer substitutes than in the past, thus removing major incentives to shifting between them. It was never an optimal response to financial disturbances to adjust exchange rates within the EMS, though it was occasionally seen as necessary or as providing a useful occasion for triggering realignments which were basically justified by other factors. Accommodating portfolio shifts through coordinated intervention and stabilisation policies is a superior method of adjustment [14], and the EMS participants have taken significant steps in the direction of strengthening these cooperative mechanisms, notably in the so-called Basle-Nyborg Agreements of 1987. Fixing exchange rates permanently should remove most financial disturbances at source.

Argument 4: Several economists, in particular Dornbusch (1988), have argued that there are important public-finance arguments for allowing significant differentials in national inflation rates. Within an EMU governments in Italy, Spain, Portugal and Greece would find it hard to compensate, through increases in other taxes and/or by cutting expenditures, for the seignorage gains they have made in the past decade and a half of relatively high inflation. A rapid rate of increase in the demand for non-interest-bearing currency in circulation - rising broadly in line with nominal incomes - and of required reserves, typically remunerated at below-market interest rates, held by the banking system, has provided automatic low-cost financing of significant proportion of large public deficits. Becoming part of an EMU committed to low inflation would remove most of this inflation tax, not easily replaceable by other forms of taxation or expenditure cuts.

On closer examination much of the alleged cost of exchange-rate fixity turns out to be of secondary importance. The seignorage gains were exceptionally large in the decade of 1975-85; they have already been very significantly reduced; they are currently of the order of 1/2 % of GDP for Italy and Spain and about twice that for Portugal and Greece (see Gros, 1989a). Regardless of whether EMU is established or not, the scope for extracting seignorage would narrow, as financial integration forced those countries that operate relatively high reserve requirements (and/or pay low interest on such reserves) to reduce this tax on their banking systems. Furthermore, part of the loss of revenue would be offset by the seignorage gains made by an ESCB, once the latter began to issue a common currency and presumably to remit part of the proceeds thereof in some form to participants. The actual loss before that occurred would be far smaller that the figures mentioned, because even a zero-inflation economy reaps some seignorage gains. On the whole, the issue does not provide any important justification for high and differentiated inflation rates.

[14] Advocacy of tighter management of the global exchange rate system is primarily motivated by the observation that in today's world financial disturbances tend to be more important than real disturbances; it is primarily with respect to the latter that preservation of exchange-rate flexibility can be justified, see e.g. McKinnon (1984).

The four more specific arguments advanced in favour of retaining use of realignments as a policy instrument for macroeconomic adjustment do not appear to be decisive. One of them (portfolio shifts) in fact points to benefits from locking exchange rates; two others carry limited weight (accommodation of residual autonomous inflation differentials; seignorage gains), given the convergence that has already taken place in inflation rates or the pressures from integrated financial markets. Only the loss of the potential to influence competitiveness through changes in the nominal exchange rate may qualify as a major cost in the historical context of the adjustment of the European economics in the 1990s. But in this context realignments would in any case have to play a minor role relative to other methods of adjustment, while financing of external imbalances would be more easily sustainable.

Most of this section has examined potential costs of irrevocably locking exchange rates while arguing that they have already to some extent been incurred by participants in the present EMS and that time is working to reduce these further. The benefits have been stated more briefly. They accrue primarily in the form of greater predictability and stability of the future price level for most participants, and firmer protection against nationally-engineered policy shocks.

These benefits of irrevocably-fixed exchange rates are still - despite the sparing use of realignments in the EMS since 1983 - some way from being realised. Nor is it obvious that they could be realised fully without the additional step of introducing a common currency to underline the definitive nature of EMU and eliminate the inconveniences that would remain in managing an economically and financially integrated area with twelve national currencies. To us the benefits of irrevocably fixing exchange rates are in themselves already sufficiently substantial to offset the costs outlined above. But the move to a common currency would in our view more decisively shift the balance of costs and benefits in favour of the latter. Hence we deal with these benefits in the following section.

3. Additional benefits from a common currency

The irrevocable locking of exchange-rates eliminates exchange-rate variability, so what additional benefits can one expect from a common currency? The introductory section about the meaning of the term 'monetary union' has already discussed in what respects a system of irrevocably-fixed exchange rates differs from an area with a common currency. That section argued that transactions costs and the impossibility to make the 'irrevocable' commitment to fixed exchange rates totally credible constitute the main differences between irrevocably-fixed exchange rates and a common currency. This section will therefore briefly discuss

five sources of additional benefits from a common currency.

Elimination of transaction costs

1) The most obvious reason for expecting significant economic gains from the introduction of a common currency is that this is the only way to totally eliminate all exchange-rate-related transaction costs. The direct savings of these transaction costs arise from the bid-ask spreads and other commissions on foreign exchange-rate transactions. As mentioned in section 1, they are large - 2 to 5% and more for cash - but since (intra-EC) tourism does not account for a large share of the GDP of the Community their total should be small. For intra-EC trade, which accounts for about 20% of the GDP of the Community and which is handled mostly by the corporate sector, the bid-ask spreads and other commissions are much smaller, depending on the currency, but generally below 0.5%.

The direct savings in transaction costs should therefore be small, perhaps around one-quarter to one-half of 1% of the GDP of the Community (still about 10 to 20 bill. Ecu per annum in absolute terms). [15]

Elimination of information costs and of incentives for price discrimination

2) While the direct savings in transaction costs might be small, the persistence of national currencies can still imply large indirect costs because it allows firms to engage in price discrimination between national markets. For consumers, used to evaluating prices in their own national currency, it is inconvenient and difficult to compare prices in different currencies, even if the exchange rate is fixed. The practice of retailers in border areas, using approximate 'round' exchange rates several percent away from the true rates, indicates that this implicit information cost can be quite high.

An order of magnitude for the welfare gains from the suppression of exchange rates can be estimated using the range of estimates from the *Cost of Non-Europe* study which found that the suppression of all residual barriers to intra-EC trade should raise the GDP of the Community by 4.5 to 6.5 %. [16] The higher value would result from a complete elimination of price discrimination and might there-

[15] With intra-EC trade equal to about 20 % of the Community GDP, the total savings of transaction costs would be about 0.2 % of EC GDP if these costs (the direct ones in the form of bid-ask rates plus the indirect, in house ones for enterprises active in intra-EC trade) were about 1 %. To this one should add the savings from tourism and other retail cross-border activities.

[16] See Michael Emerson, 'The economics of 1992', *European Economy* 42, March 1988.

fore be attainable only with a common currency. This would imply that the benefit from the introduction of a common currency could be as large as 2 % of Community GDP (about 80 bill. Ecu in absolute terms).

Dynamic efficiency gains

3) An even more speculative reason to expect large economic gains from a common currency derives from the its dynamic effects. Economists have long recognised that the most valuable benefits from integrating markets are of a dynamic nature. However, until recently these dynamic effects were difficult to measure since there did not exist an adequate theoretical framework to explain continuing growth that was not simply the result of exogenous technological progress. The models that have been developed recently to explain what factors aside from exogenous technological progress could lead to growth are still in an early stage but they can, in principle, be used to assess the dynamic impact of the introduction of a common currency. [17] While it seems very difficult to assess the exact magnitude of the increase in the growth potential of the Community through monetary union, it is clear that these dynamic effects could easily dwarf the once-and-for-all efficiency gains whose magnitude can be more easily assessed because even a small increase in the growth potential has an exponentially-increasing effect on the level of income over time.

Need for less official international reserves

4) A more macroeconomic source of benefits is the savings in terms of international reserves. As long as national currencies subsist, national monetary authorities have to keep large foreign exchange reserves to be seen to be able to defend exchange rates. National economic policy-making in general may also be more constrained because certain actions could be interpreted as weakening the commitment to keep exchange rates fixed. The direct cost of holding reserves should be small, since they can be invested in interest-bearing assets, but the cost of acquiring and maintaining confidence in the exchange-rate commitment might be large, especially for countries without a history of stable exchange rates. The importance of this last consideration would, of course, depend on how successful the intermediate stages have been in reducing *de facto* exchange-rate stability. A long period of time without realignments in the EMS would, of course, strengthen the credibility of irrevocably-fixed exchange rates and lessen the need to hold large

[17] P. Romer (1989), 'Increasing returns and new developments in the theory of growth', *NBER Working Paper No. 3098* (September 1989).

foreign exchange reserves. In general, the faster the movement towards monetary union the bigger these benefits from a common currency. [18]

Stronger European presence in the international monetary system and in global financial markets

5) Another potentially-important source of benefits from a common currency is external. A single European currency would at least partially replace the US dollar in some retail transactions around the world. The direct seigniorage gain for the European central bank that would result from this would be small, perhaps at most a once-and-for-all (as opposed to the efficiency gains which would be available year after year) gain of 30 billion Ecu (equivalent to an efficiency gain of 2.4 billion at an interest rate of 8 % [19]). Much larger indirect effects could, however, result from large-scale international portfolio substitution away from the US dollar into the European currency. This might be a mixed blessing, however, since it could have an undesirable effect on the exchange rates of the European currency against the dollar, causing the latter to move below a longer-run sustainable level.

4. The relationship between economic and monetary integration

The Delors Report stresses that 'economic and monetary union form *two integral parts of a single whole* and would therefore have to be implemented in parallel' (para. 21, italics in original). The same principle is emphasised in the report's proposed steps towards EMU (para. 42).

By linking economic and monetary integration the Delors Committee fulfilled a mandate given to it by the European Council. It did so, moreover, in terms familiar from EC debates since the Werner Report of 1970, which was a compromise between two schools of thought, labelled as 'economic' and 'monetarist'. The former finds its most recent expression in the view that monetary union in the sense of irrevocably-fixed exchange rates and the introduction of a common currency should be the end result of a very long process of economic convergence - a 'coronation

[18] One could also argue that some interest-rate differentials will continue as long as the exchange rate commitment is not fully credible. The Dutch-German and the Belgian-Luxembourg examples that are used in section 1 suggest these differentials should be small, but their very existence indicates that there is a distortion which operates like a (small) tax on trade.

[19] This figure is based on estimates that about 130 billion US dollar notes are used outside the US (presubably most of it in Latin America), one-third to one-quarter of which might be converted into Ecu.

act'. The latter holds that monetary integration triggers economic integration and may therefore usefully be allowed to run ahead of the latter, while monetary union would in itself put such constraints on both governments and markets that no further explicit efforts at economic integration would be required.

An apparent common-sense compromise between these two views of the relationship may not in fact be soundly based. The Delors Report itself recognises the difficulties when it says (para. 42):

> Perfect parallelism at each and every point of time would be impossible and would even be counterproductive. Already in the past the advancement of the Community in certain areas has taken place with temporary standstill in others, so that parallelism has been only partial. Some temporary deviations from parallelism are part of the dynamic process of the Community.

Although a major effort is now being made to make some parallel progress in cooperative mechanisms in the monetary and non-monetary areas in stage one, as commented on in the next part of this paper, the mere difficulties of assessing whether they can be regarded as parallel are daunting. But with respect to the final stage of union the Delors Report is more unambiguous in stating four basic components of the economic dimension of unification (para. 25):

(1) the 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 structural change and regional development; and

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

The first three of these components is already well on its way to realisation, as a result of decisions largely taken before the present discussion on EMU was launched; in that sense one may say that economic integration would have been about to move ahead of monetary integration in the absence of any initiatives in the latter area.

(1) Although there are delays in the timetable, the passage of the 279 proposed directives which remain from the EC Commission's White Paper of 1985 is well on its way through the Council of Ministers.

(2) Competition policy is being reinforced in such areas as coordinated approval by national and EC authorities of mergers and acquisitions and a firmer line by the Commission on state aids to industry.

(3) A doubling of EC structural funds in the period up to 1993 was adopted in February 1988; under this programme transfers to the weak peripheral economies (Greece, Ireland and Portugal) will reach a size of 4-5% of their respective GDPs. The Delors Report is careful not to say *a priori* that this very substantially increased level of transfers will be insufficient to sustain also the participation of the currencies concerned in an EMU, but that is obviously an issue to be carefully examined during stages one and two.

The final component of economic union required to achieve parallelism with the ultimate step in monetary integration of locking exchange rates irrevocably is, in the Delors Report's vision, coordination of national budgetary policies going well beyond voluntary efforts on the part of each participant. Few would dispute that fully-fixed exchange rates and a joint institutional framework to manage the common monetary policy, which would be required in such a regime with all controls on capital flows removed, is the final step in monetary integration. But there is a wide divergence of views as to whether that needs to be parallelled by giving a collective body - the Council of Ministers of Economics and Finance - the authority to intervene in national budgetary policies in a binding way. Objections may be raised on both economic and political grounds to this interpretation of parallelism. [20]

The economic objection is that such intervention would be superfluous in an EMU, since the fixed exchange-rate system, underpinned by a common monetary policy (collective formulation of monetary targets and of intervention policy vis-à-vis third currencies) would adequately constrain budgetary policies. Some see a virtue of EMU in its capacity to sharply reduce the need for discretionary coordination of non-monetary policies. That would be desirable, both because of the past failure to get to grips with such coordination between the EMS-countries and at the global level, and because of the inherent difficulties and arbitrariness of the exercise; macroeconomic models of international interaction have taught us that the gains from policy coordination are ambiguous because not enough is known how economies interact and react to specific policy actions.

The political objections are twofold: 'binding rules' on the size of national budget deficits would be perceived by any government as a strong infringement of sovereignty, and there are very major difficulties in seeing how they would be implemented. Many national governments find it impossible to observe budgetary guidelines they have voluntarily adopted; and most governments refrain from

[20] The following draws heavily on Thygesen (1989b).

imposing binding rules on regional or local authorities.

Why then did the Delors Report insist on budgetary rules? Could they be, as some have mischievously suggested, an effort by the central-bank majority in the Delors Committee to put up a roadblock to EMU more likely to deter their governments from the venture than the abolition of residual national monetary autonomy? There are three arguments in the Report which are elaborated in the contribution of Professor Alexandre Lamfalussy to the Collection of Papers published with the Report.

(1) The EC central budget is too small to achieve a proper policy mix in EMU

The European Community is very different from large federal states. The EC budget, currently little more than 1% of the combined GDP of member states, is too small to exert any significant stabilisation function. For the foreseeable future, influence over the aggregate budgetary stance can only come via decisions on national budgets. An EMU whose members have preached to other major industrial countries the virtue of a correct mixture of monetary and fiscal policy cannot leave itself with no effective means to influence that mixture.

Large federal states permit themselves to be more relaxed about budgetary policies of regional governments because a federal budget of typically 20-30% of GDP provides ample potential leverage. When imbalances in the policy mixture appear, they are not due to insufficient centralisation of budgetary authority.

Two points are worth observing, however, about the exercise of central EC authority to get the policy mixture right: (i) there is no logical reason for it to be asymmetrical, i.e. directed only at excessive aggregate budget deficits; (ii) it is not obvious that binding rules are required. Careful reading of the Delors Report will show that the Committee was aware of both (para. 30).

The policy mixture may become inappropriate because national budgetary policies are in the aggregate too restrictive. Such a situation would be characterised by a rising current account surplus for the area as a whole (or by a reduction of an area deficit regarded as globally appropriate) and by upward pressure on the exchange rate of the union, unless compensated-for by monetary expansion ('unsterilised' purchases of third currencies or a lowering of interest rates undertaken to prevent the need for such interventions), considered inappropriate in a perspective of long-term price stability. For some time such a situation may be unlikely for the reason mentioned under (3) below, but whatever authority is ultimately vested in the Council of Ministers as a result of this argument should, in principle, be proportionate to its responsibilities.

It would be difficult to justify binding constraints solely with reference to

the argument on policy mixtures. Across-the-board proportional adjustments of budgetary balances may well be recommended as appropriate and they will become increasingly logical as EMU deepens integration. But given major differences between national budget positions for any foreseeable time, they would be regarded as arbitrary and unenforceable. A differentiated judgement would be required: which brings us to the second argument for binding rules aimed at the international cohesion of EMU.

(2) National budgetary deficits could threaten the credibility of fixed exchange rates

Large budget deficits, particularly if they come on top of already large debt-to-income ratios, may threaten the fixity of exchange rates until the credibility of EMU has been firmly established, as they have on occasion unsettled the EMS. This is an argument for insisting on better budgetary convergence in the transitory stages, but not necessarily for binding rules once EMU has been set up.

Whatever the exchange-rate régime there are international externalities to a country's budgetary policies. In a régime where exchange rates are either flexible or where governments occasionally have resort to realignments, important elements of those externalities are deflected into movements in the currency of the initiating country. To this extent the consequences of budgetary expansion fall primarily on the country itself as domestic investment is in part crowded out. Some externalities remain for the country's partners: shifts in comparative conditions, as devaluations occur and are subsequently eroded, and direct-demand spillover from the deviant budgetary policy.

Spillover effects of a different nature may arise if excessive budget deficits lead to a risk premium required by investors to hold assets denominated in the currency in question. With exchange rates at least potentially flexible the risk premium and the wealth losses imposed on domestic asset holders and on those (including the government) who have borrowed in foreign currencies would be borne by the country itself. However, with fixed exchange rates investors might require a risk premium on assets denominated in any of the currencies of the entire area.

The closer one moves to full EMU the stronger these externalities become. [21] Economic integration and monetary unification increase the transmission of budgetary impulses as they are to a diminishing extent contained within

[21] For a thoughtful discussion which reaches a more agnostic conclusion, see Bredenkamp and Deppler (1989).

the borders of the initiating countries. In integrated financial markets the interest-rate effects of national budgetary policies are more imperceptible and shared by all participants. In order not to encourage free-riding on partner countries the imposition of some central authority becomes more necessary than in the present, more decentralised system.

Furthermore, some individual member states have budget deficits that are large relative to the EC - and much larger than those of single states in most existing federations. A deficit of 10 % of GDP in a large member state corresponds to more than 1 % of collective GDP and to more than 5 % of EC net savings. Borrowing by a large member state is in a different category from that of even the biggest private firms or public enterprises. The absorption of a substantial part of EC savings by large and persistent deficits would raise political pressures for correction of undesired externalities for other member states. While this line of reasoning may apply only to the actions of large member states, 'binding rules' would have to apply potentially to all.

Though the international system - and the EC - has traditionally been more tolerant of imbalances in small than in large industrial countries, there could hardly be positive discrimination in favour of the former in a new mandatory system. The authority to set 'binding rules' could serve to prevent more improvised and brutal pressures for adjustments late in a process of divergence.

3) EMU could bring fiscal laxity

The launching of an EMU without any mandatory budgetary coordination could encourage an excessively-lax aggregate fiscal stance. Some who favour the rigid locking of exchange rates in EMU over present arrangements do so because the financing of external deficits becomes more automatic and the potential effects of fiscal policy more predictable and possibly larger. A policy-adviser can find good arguments for concluding that ambitions in fiscal policy can be raised once exchange rates are fully fixed. A policy-maker, no longer confronted with pressures on the currency or of large reserve flows, may more readily follow the advice.

This attitude, if widespread - and if consciously adopted by several member states - would, indeed, create a bias towards budgetary laxity. Such a bias may anyway be observable in the transitory stages, as greater homogeneity of national tax régimes is approached through lower indirect and direct taxes in high-tax countries rather than by tax increases elsewhere. Given the starting point of major differences in national budgetary stance and the likely further sources of divergence in the 1990s, there is hardly scope for encouraging licence in budgetary policy.

But if fiscal laxity did follow EMU the other two arguments above would both be reinforced.

The three main arguments for binding rules for budgetary policy are difficult to refute, but they would not be conclusive, if alternative disciplining mechanisms were available. Participation in EMU would eliminate the escape route of devaluation and surprise inflation which has in the past occasionally reduced the real value of public debt. Participation in a fully-integrated European financial area opens captive national markets for public debt where governments could finance deficits at below-market interest rates through high reserve requirements on bank deposits and compulsory minimum holdings of government debt. With these privileges gone, would financial markets undertake a straight professional evaluation of the varying degrees of credit-worthiness of national governments? Those persisting in rapid issues of debt would face rising borrowing costs and some outright rationing of credit.

The Delors Report is not convinced that these mechanisms would provide adequate constraints on budgetary divergence. The experience of large federal states suggest that the sanction of an inferior credit rating is of minor importance. Within Canada, where the divergence in budgetary stance and in indebtedness is wider than in other federations, the range of borrowing costs spans less than 50 basis points. Within the United States borrowing costs show a similar lack of sensitivity to the budgetary policies of states. Financial markets at first had difficulties in assessing properly the credit risks attached to Third World sovereign borrowers, then in 1982 reacted sharply and almost indiscriminately as the prospects for debtors worsened.

Could financial markets apply a more graduated discipline to the borrowing by member states in an EMU? That is possible; and they might discriminate more than between Canadian provinces which for more than a century have been part of a monetary union. But financial markets might still primarily interpret the formation of EMU as an upgrading of the credit-worthiness of weak members. This might still apply even if the central authorities of the EMU were to state explicitly that they would not provide bail-out facilities - an 'umbrella' - for member states. Participation in the EMU could therefore effectively protect deficit spending from market pressures.

Even those who accept the arguments in favour of mandatory budgetary coordination and share the view that financial markets will not provide a substitute discipline have doubts about how the proposal would be implemented and enforced. The Report speaks only about imposing 'upper limits on budget deficits'. Usually such deficits are expressed relative to GDP - a crude measure, unless much attention is devoted to individual situations, including the balance of private savings and investment. Convergence of performance may at times require further divergence of national budgetary policies. For example, some would currently say that the UK public sector surplus is too small, as are the deficits in some other member states. How could one then provide guidelines for budgetary policy? The most logical approach would be to intervene in a country's policy only if it becomes a threat to the fixed exchange rate system. That will not however, provide a clear operational criterion: the ECOFIN Council would be guided by its collective doubt that a government could fulfil its commitment to fully fixed exchange rates without monetary financing, which would, in principle be, excluded in an EMU - but the Council could hardly be seen to voice such doubts explicitly.

Ideally, the major budgetary deficits observable as the process towards EMU begins would be corrected during stages one and two by the voluntary efforts of individual member states, aided by the non-binding recommendations addressed to them through the reinforced convergence procedure envisaged for these stages. But even promising developments of this kind over the next two years would not relieve the forthcoming intergovernmental conference of the responsibility of coming up with operational suggestions for a mandatory budgetary coordination procedure, meeting the quest for parallelism between monetary and economic integration to which most member states claim to adhere. Should 'rules' be taken literally, or could some discretion be applied? Should they be addressed to budget forecasts or to actual figures? What is the appropriate time horizon? How could collective decisions/recommendations be enforced? Only very superficial answers can be given to these questions in the present paper which is largely addressed to the monetary aspects of EMU.

The simplest type of rule hinted at in the Delors Report is *to relate the maximum permissible deficit directly to GDP.* For reasons already given, however, that would be too crude a measure, as one would want to relate it also to the private savings-investment balance of the country; for this reason alone it would be impossible to apply uniformly. The Delors Report itself hints at this in saying (para. 30) that 'the situation of each country might have to be taken into consideration'. Could other generally applicable rules be envisaged?

References to the absence of Federally-imposed constraints on state deficits in the United States often omit to point out that a large number of states have adopted 'balanced budget amendments'. This is just a particular version of a uniform ceiling on the deficit; it would be too rigorous in a Community with wide differences in budgetary positions and public debt/GDP-ratios ranging from 37% in France to 128% in Belgium (disregarding Luxembourg with only 10%). Allowance would have to be made for the equally-wide differences in the net costs of debt servicing which these differences in debt impose on national governments.

The simplest way of making such an allowance would be to set *a rule for the primary deficit*, i.e. the deficit net of interest payments. If monetary financing is excluded - as is proposed in the Delors Report for EMU - and nominal interest rates converge between countries, and correspond approximately to the growth of nominal incomes in the participating countries, the primary deficit relative to GDP would fully determine public debt accumulation relative to GDP. A conceivable formulation of a rule, provided these (rather strong) assumptions are roughly met, would be to aim for a primary deficit of zero. Analytical methods are available for studying the consequences of relaxing these assumptions; at least in the early phases of EMU large debtor governments might still have to pay a premium on outstanding debt which is not offset by faster growth in their nominal GDP, so that their debt/income ratio would rise even with a zero primary deficit. In principle, one could try to determine analytically a sustainable trend of public debt and derive the implications for the maximum primary deficit compatible with such a trend. [22] But there are two objections to such a procedure. First, the estimates would be surrounded by a very considerable margin of uncertainty, leaving much room for divergent interpretations by EC and national authorities. Second, the rule would appear to be too lax; in 1988 only two EC countries - Greece and Italy - had a primary deficit (corresponding to 5.5 and 2.3 % of GDP, respectively) while most other countries ran sizeable primary surpluses in order to contain the impact of the tendency, observable throughout most of the 1980s, for nominal interest rates to exceed the growth rates of their nominal GDPs and, beyond that, to reduce the debt ratio. An EMU would not want to be seen to encourage relaxation of such efforts. [23]

These preliminary remarks may suffice to indicate that even the substantial allowances for differences in initial national situations are inadequate for establishing a generally applicable rate. One is led, inevitably, towards the consideration of more discretionary methods of formulating the collectively-agreed budgetary guidelines. This implies that a recommendation which a (qualified?) majority in the ECOFIN Council could agree to address to a participant would constitute a 'rule' in the sense that non-compliance with it would trigger some form of sanction on the part of the Community. There is, realistically, little reason to think that the ECOFIN Council would use such authority frequently and vigorously; the past history of the Community clearly suggests that this is more than unlikely.

[22] For an effort along these lines see *European Economy* No. 42 (Special Edition), EC Commission, Brussels, October 1989, pp. 145 ff.

[23] *Ibid.*, p. 143.

The Council has never been demanding, for example, in administering its medium-term financial support system. Nor has the EC Commission, with which the initiative to implement the guidelines would rest, shown any eagerness in the past to use the authority which it has had since 1974 to issue recommendations to a member state; in nearly 16 years it has only acted once.[24] The challenge in EMU is to encourage the Council and the Commission to be a bit less cautious in confronting national policy-making than they have been in the past.

One element to keep under observation is that the binding guidelines could hardly apply to budget forecasts only; they would have to trigger corrective actions as a function of *actual budget out-turns*. In the United States Congress has adopted constraints on the forecast budget balance through the Gramm-Rudman-Hollings Act, which prescribes proportional cuts in a range of specified expenditures if the deficit forecast for the coming year contravenes a prescribed downward trend. There is no subsequent sanction if the actual budget deficit is excessive. This procedure initially generates disputes about the economic assumptions underlying the budget forecasts and incentives to push some expenditures off-budget; and subsequently, no systematic effort to rectify deviations. Similar disputes would arise, in an even more acute form, over budgetary guidelines within the EMU. Analogous European procedures, in the rare cases when they are applied, should aim at making governments accountable for their actual budget performance and link eventual corrective actions to transgressions of actual over-targeted budget deficits.

Finally, as regards the *time horizon* for the budgetary rules, their purpose would not be to serve short-term, activist aims, but to keep participants on a medium-term course of debt accumulation (or reduction) which is sustainable in terms of maintaining the cohesion of EMU. Binding guidelines would accordingly be formulated for a period of several years, though mandatory for each budget year within that period. One difficulty in using the (non-binding) authority under the 1974 Decision may have been that its premise was an ambition to pursue more activist stabilisation policies than was either economically desirable or politically realistic.

5. Issues for the transition: convergence and membership

This part of the paper has analysed the costs and benefits from a monetary union

[24] Article 17 of the 1974 Decision on convergence entrusts the Commission with this task, if a member state is 'pursuing economic, monetary and budgetary policies departing from the guidelines laid down by the Council or entailing risks for the Community as a whole.'

so far without taking into account the transition. However, the transition also involves important issues although they are difficult to classify as economic costs or benefits. This section therefore briefly discusses how the transition to monetary union should be organised from a macroeconomic point of view. Part Two of the paper then discusses somewhat more extensively the institutional requirements for the transition. Since the introduction of a common currency does not pose any issues for the transition (except the practical problem of how to organise the substitution of national currencies), this section discusses only the transition towards the irrevocable fixing of exchange rates.

The main issue for the transition to monetary union is the need to achieve convergence of inflation to the low level achieved in the anchor country of the EMS, the Federal Republic of Germany. Given the wide agreement on price stability as the main aim for the future common monetary institution, this is likely to be the standard for some time to come. A monetary union would clearly be unstable, and undesirable from an economic point of view, if wages and prices in some region deviated more from the average than could be justified on the grounds of differences in productivity, industrial structure or the price of non-tradable goods, such as real estate. However, the experience of existing monetary unions, especially that of large federations, suggests that the differences that can be caused by these factors are minor, in the order of magnitude of 1 % per annum. Moreover, they tend to cancel out over time so that over longer time periods, e.g. a decade, the cumulative difference in wages and consumer prices is much smaller.

While it is clear that a monetary union requires almost complete convergence in inflation it is less clear how this convergence can be achieved. The basic issue, which has been debated for a long time, is whether inflation convergence can be achieved by fixing exchange rates or not.

One extreme view, which one might associate with the 'coronation theory', seems to hold that inflation cannot be influenced by the exchange rate, and therefore it would be necessary to wait for a full convergence of inflation before it is advisable to go to monetary union by irrevocably locking exchange rates. This view implies that transition to monetary union could be rather long since it is clear that it would take some time to eradicate the inflation differentials, more than ten percentage points between Germany and Greece, that exist at present.

The opposite view holds that a credible commitment not to accommodate inflationary pressures from excessive wage settlements would impose enough discipline on trade unions and employers to ensure a rapid convergence towards low inflation rates. The experience of the EMS suggests that a credible exchange rate commitment can indeed have a disciplinary effect. However, in the EMS realignments are always possible, and in the past were expected to occur with a certain frequency. This safety valve would no longer exist in a monetary union and one could therefore expect the disciplinary effect of participating in a monetary union to be much stronger than that of the EMS.

This implies that it would not be necessary to wait for a complete convergence of inflation before passing to the final stage of irrevocably locking exchange rates. The experience of the EMS suggests that in most countries the wage- and price-setting mechanism is sufficiently malleable to ensure that a residual inflation differential of one to three percent could be eliminated very rapidly. [25]

It is often argued that a low inflation rate can be maintained only if it is not accompanied by large external or internal disequilibria. This raises the issue of to what extent the passage to a monetary union also requires convergence in public deficits and debts and even perhaps current accounts. Convergence or overall equilibrium in current accounts should not be regarded as a precondition for the establishment of a monetary union since inside the union current accounts would become irrelevant, and, once there is a common currency, would also no longer be recorded.

The only remaining convergence issue is therefore the degree to which there is also a need to achieve convergence or coordination in fiscal policies. This issue was already discussed in the previous section, where it was argued that there is a need to create safeguards against excessive deficits or debts that could threaten the stability of the monetary union. Since experience shows that the reduction of debt levels, and in some cases even that of deficits, is a slow and difficult process, it follows that some of these safeguards, in the form of 'binding guidelines' for fiscal deficits and debts, should already be applied in the transition to ensure that no country enters the monetary union with a public debt that might threaten the stability of the union.

In their transition towards a credible commitment to keep the exchange rate within the EMS bands, and later to irrevocably fix the exchange rates without bands, most countries will have to go through a period during which the credibility of the authorities is not yet firmly established. It has been argued that if this happens in an environment of completely liberalised capital markets there is a danger of self-fulfilling speculative attacks. According to this view a crisis could be caused by a difficulty to roll over government debt or simply a doubt in the financial markets about the commitment of the authorities to defend the exchange rate. In such a crisis speculative flows out of the currency could exceed the foreign ex-

[25] This requires, of course, that backward-looking indexation schemes be either abolished or suspended for the transition period.

change reserves that can be mobilised at short notice, i.e., flows longer than the Very Short-Term Facility, and therefore constrain the authorities to abandon the defence of the exchange rate, thereby validating the original doubts.

That the possibility of such self-fulfilling crises must be linked to a less than fully credible commitment to defend the exchange rate is clear from the Dutch experience since there has never been any speculative attack on the Guilder/DM rate. The main reason for this must be that, in spite of the high Dutch public deficits and debt, the commitment of the Dutch authorities to do whatever is necessary to defend the Guilder/DM rate is not subject to any serious doubts in financial markets. Such a degree of credibility can, of course, only be established after some time, but in the meantime the use of the bands should give the authorities the necessary degree of freedom in case there is some turbulence in financial markets. In extreme cases, if a small realignment becomes inevitable, the use of overlapping bands would also allow the authorities to make sure that speculators cannot reap large benefits.

What does this necessarily superficial discussion of the macroeconomic requirements for the transition imply in terms of the real world, i.e. the individual member states of the Community? Since almost no two countries are in the same situation, the remainder of this section discusses very briefly on a country by country basis what adjustment would be required before the country could participate in a monetary union.

The Federal Republic of Germany represents in many respects the model for the future monetary union. It would need only to maintain its record of prices stability and the current near-balance in the accounts of the government.

The Netherlands has already achieved full convergence in its prices and wages relative to Germany, but the debt to GDP ratio, about 80 %, is above the Community average and the current deficit would not lead to any reduction of the debt burden. Some fiscal adjustment would therefore be desirable, but probably not indispensable since the current debt can be serviced without major problems.

Belgium and Luxembourg, which already form a two-country monetary union, have not achieved the same convergence in inflation as the Netherlands. However the difference has now almost been eliminated and would disappear once it became clear that realignments were no longer possible. The major issue is therefore the large debt of the Belgian central government, only part of which would be transferred to the two main regions taking over important economic policy functions. The current debt-to-GDP ratio, about 120 %, is the second highest in the Community and would almost certainly fall under the 'binding guidelines' for fiscal policy. Action on this front is all the more urgent because with the currently high real interest rates the small primary surplus is not sufficient to keep the debt from rising.

France has also, but more recently, achieved convergence in wages and prices in order to participate in a monetary union. Given the sound French public finances the only remaining issue is the external current account, which shows a small deficit (at present less than 1 % of GDP). However, since this deficit can easily be financed by the financial markets and since it does not seem due to a large overvaluation of the French franc, even this element should not constitute an obstacle to French participation in a monetary union. On the contrary, the introduction of a common currency would mean that the occasionally-excessive attention given to the trade balance by French policy makers would disappear.

Denmark and Ireland have both made very substantial corrections of their large public sector deficits of the early 1980's and have reduced their inflation differentials over Germany to less than 2 percentage points. Ireland has achieved a current account surplus and the Danish external deficit has been shrinking for the past three years. Yet the stabilisation efforts of these two countries remain less than complete, particularly when it is kept in mind that they rely on indirect taxes to an extent which will require modification towards a Community average. In order to prevent a sharp worsening of their public sector deficits these two countries would need to pursue during the transition period more restrictive public expenditure policies than in the recent past. There would be strong economic arguments for such a course since both economies would be stimulated both by lower taxes and by the reduction of high interest rates as the fixity of exchange rates became steadily more credible.

Italy still has an inflation differential, relative to Germany, that suggests that further realignments would be necessary. But if it were able to follow the example of France this differential could be almost eliminated within a couple of years and would then cease to be an obstacle. This view would also justify the decision taken by the Italian authorities in January 1990 no longer to use the 6 % margin for the lira. The second problem in the case of Italy is public finance. The debt-to-GDP ratio has now attained almost 100 % and is still rising. Moreover, the experience of the past years suggests that it might be difficult to service that debt because the political system is such that a large part of expenditures cannot be reduced and it is becoming increasingly difficult to raise additional tax revenues. Also because of the sheer size of its deficit (not far from the US deficit in absolute size), Italy is another prime candidate for 'binding guidelines' for fiscal policy.

Spain has achieved about the same inflation performance as Italy and would therefore also not be far from being able to join a monetary union. Since the debt-to-GDP ratio is much lower than in Italy its public finances are also less of an obstacle. However, it might be unwise for Spain to enter into a monetary union before it is fully integrated into the European markets. This implies that it would have to wait until all the scheduled tariff reductions have taken place and most of the internal market measures have been taken. This would also yield enough time to decide whether the external current account deficit is just a result of an investment boom, and therefore can be financed, or whether it is the result of an expansionary fiscal policy and an overvalued exchange rate that need to be adjusted.

The United Kingdom has so far refused to join the EMS. Perhaps as a result, inflation has not come down to the level of the average of the EMS and the UK pound might be overvalued if the current account is taken as the indicator. It could be argued, however, that the central issue in the case of the UK is not the current stance of macroeconomic policy or the current account, but the question of whether British trade unions and employers would ever be ready to accept the discipline of a monetary union. Only when this had been accepted would it be advisable for the UK to renounce permanently the further use of the exchange rate as an adjustment instrument.

For both Greece and Portugal substantial adjustments in almost all areas of economic policy would be required before they become candidates for monetary union. The main fields are fiscal and monetary policy which need to be tightened to allow for a reduction in inflation, which is at present still in the double-digit range. Moreover, these countries would also have to face structural adjustment problems with the creation of the internal market which might require substantial changes in their real exchange rates. However, even this substantial adjustment programme need not push participation by these countries far into the next century. If the necessary adjustment programmes were implemented now, most of the convergence required in macroeconomic terms could be achieved within a decade, since at least in terms of inflation Italy progressed even faster than thus in the 1980s.

The considerable adjustment still required in a number of member countries could also be taken as 'concrete steps' that are needed to advance towards monetary union. Steps that are a precondition for the success of the institutional steps discussed in the second part of this paper.

6. Summary evaluation of the economic costs and benefits of monetary union

In Part One we have attempted to state the main costs and benefits of moving from the present EMS to full monetary union. We defined the latter (in section 1) as an area in which the irrevocable fixing of exchange rates is followed by the introduction of a common currency. Nevertheless, we separated in the following two sections the cost-benefit analysis of those two steps. With the irrevocable fixity of exchange rates we associated above all the permanent loss of exchange-rate changes as an instrument for macroeconomic policy-adjustment. Though this is indeed a cost, we argued that much of it has been incurred already by the present members of the EMS who have used the instrument to a diminishing extent over the past decade. Some of the traditional arguments used for retaining it have weakened considerably (accommodation of residual, autonomous inflation differentials and the public finance arguments for not removing seignorage) while one could be reversed: portfolio shifts are better accommodated within a fixed rate system than by letting the exchange rate move. The main argument to which we would continue to attach importance is that there is still some risk in discarding any instrument that may reduce, however limited the scope for a significant contribution may be, the initial external imbalances of the prospective participants.

Against these costs one would have to be set the mainly microeconomic benefits of a fully stabilised exchange-rate system. One point of separating the irrevocable fixing of rates from the subsequent step of introducing a common currency is that only the latter step assures that all these benefits will be fully reaped: full convergence of nominal interest rates and of inflationary expectations, disappearance of transaction costs and greater transparency in the environment for the internal market in goods and in financial services.

We dealt more superficially with the economic aspects of integration, in part because it is more difficult to determine what they imply. Our discussion of budgetary rules in an EMU, the most controversial part of the recommendations in the Delors Report, concluded that while there would be stronger spillover effects of national budgetary policies in an EMU than in the present system of fixed-but-adjustable exchange rates and imperfect financial integration, it would be difficult to formulate and implement rules regarding short-run demand management. However, concerns about the systemic stability of EMU can justify more interference in budgetary policies, especially when public debt or deficits threaten to become unsustainable. Insistence on their use could conceivably lead to costs that would outweigh the benefits. If so, that would be a net cost associated with a monetary union which would have to be evaluated against the net benefits which we attribute to the monetary aspects *per se*.

Part II
Concrete steps

1. Institutional versus market-led approaches to monetary union

Part one of this paper has argued that a monetary union with a common currency would bring sizeable net economic benefits. For some observers a natural corollary has been that no further official action to create new institutions is needed because if the gains from currency unification are real they will lead markets to move spontaneously towards the adoption of a single currency. The only official action required would be to eliminate all legal restrictions that impose the use of national currency. It would not be necessary to fix exchange rates and coordinate national policies. This section therefore discusses two closely related variants of this idea: the parallel currency approach and the competing currencies approach.

The economic logic behind the general idea is quite straightforward: in general competition is the best market structure; it should therefore also be applied to choice of money. At its logical extreme this line of thought would imply that there should be free private issuance of money. The public would then choose the best one, presumably the one that is the most convenient because it offers the most stable purchasing power. This might be called the *competing currencies approach*. [27]

The logic of this approach is undeniable, but it implies that the monetary constitutions of almost all countries of this era are fundamentally flawed because they give the government a monopoly on the issuance of money. The proponents of this approach might argue that the reason for this discrepancy between theoretical optimum and reality is political in the sense that governments want to keep a source of potentially large seigniorage gains under their control. However, even from a purely economic point of view one could argue that there are important economies of scale in the choice of money. The benefits from a common currency discussed above are indirect expression of these economies of scale and the estimates of the order of magnitude of the potential benefits imply that they can be quite important. Free competition is in general not the optimal market structure if there are external [28] economies of scale. It is therefore possible to make

[27] See F. Hayek (1984).

[28] It is crucial that the economies of scale be external. If they could be internalised by each private provider of money competition would break down, as one money would displace others and remain without competition.

a strictly economic case for a government monopoly of money and institutional steps towards monetary union.

A more popular alternative to institutional steps has focused on the private ecu. According to this so-called *parallel currency approach* the goal of monetary union might be reached with little official action if the markets were increasingly to adopt a parallel currency, the ecu, that gradually crowds out national currencies until it becomes de facto the common currency. This approach would also not rely on exchange rates being fixed; instead, through the increasing use of the parallel currency a common currency could be created without any need for the difficult process of convergence in national policies.

Institutional steps along the lines of the Delors Report are discussed at some length in section 2 below. Before going into the Delors Report, section 1 discusses the two variants of the market-led ideas: the parallel currency and the competing currencies approach. These two market-led approaches might best be thought of as substituting only for stage II of the Delors Report since if they were successful in establishing a common currency through the market there would still be a need for a common monetary institution to formulate and execute the monetary policy for this common currency. They would also be only a partial substitute for stage I of the Delors Report, since the essential element of stage I is capital-market liberalisation, which is also an indispensable ingredient of all market-led approaches.

i) The parallel currency approach

The following discussion of the parallel currency approach concentrates on the (private) ecu in its present basket form. There are numerous academic proposals based on a different, inflation-proof, ecu, [29] but these proposals seem less relevant in the present environment of low and converging inflation rates. Such an abstract parallel currency, even if 'inflation-proof' because of some purchasing power guarantee, would not benefit from the diversification element underpinning the ecu and could therefore not be expected to be successful when inflation rates were around 2 to 4 %. The only realistic remaining option for the parallel currency approach is therefore the ecu in its current definition.

Given that the purpose of the parallel currency approach is to avoid the need for fixing exchange rates this section discusses the factors that would determine the success of a parallel currency in an environment of moderate exchange rate flexibility, roughly equivalent to the situation in the Community at present. In

[29] Starting with the 'All Saints Day Manifesto', *The Economist*, November 1975.

addition it will also be assumed that there are no capital controls, no legal restrictions on the use of a particular currency and a system of national financial markets and payments systems that are in the process of integration, but still conserve some national characteristics.

Following the discussion about the meaning of monetary union it is convenient to organise the discussion around the three classical functions of money mentioned above: unit of account, store of value, and transaction medium. As mentioned above, in most modern economies one currency fulfils all three functions of money. A parallel currency could therefore out-compete national currencies only if it had advantages substantial enough to outweigh these economies of scale; a marginal advantage in one of the functions of money would not be enough.

The parallel currency as a unit of account

For large corporations with widely dispersed sales and plants the ecu might become convenient for accounting purposes if such corporations could pay taxes on the basis of their accounts in ecu or if they felt that consolidated accounts in this currency were used by the markets to determine the evaluation of the firm. The latter effect might arise only once corporations no longer had a distinct nationality, as at present. In dealing with the general public for such corporations it might also be convenient to quote one European price (net of local taxes) in the parallel currency.

This use of the parallel currency would therefore seem to depend on the extent to which the Community can be viewed as one market. The 1992 internal market programme should therefore boost the demand for a supranational parallel currency as a convenient unit of account for the unified European market. However there is little prospect that the ecu could be widely used by corporations that mainly operate on the domestic market and by households which will always do almost all of their shopping domestically.

The parallel currency as a store of value

An important element of the parallel currency approach is that a high degree of exchange rate variability would increase the usefulness of a parallel currency as a store of value or financial asset. A high degree of exchange rate variability would make financial instruments denominated in a basket currency useful because it would allow issuers and investors who desire to reduce exchange rate risk to save on the transaction costs that would arise if they had to construct a new basket each time and take out positions in each of the components. However, as the experience with the ecu shows this type of demand for a parallel currency would be restricted mainly to international corporations exposed to exchange rate variability and wealthy individuals who can contemplate investing in several currencies. Moreover, the low degree of exchange rate variability (between EC currencies) that can be expected by 1992 would further reduce the usefulness of a basket currency as an instrument for risk diversification.

The remaining predictable or expected changes in exchange rates (as opposed to the unexpected changes that constitute exchange-rate variability) should be an even less important factor in the environment of moderate inflation rates that can be expected for the 1990s. This element might increase the demand for the strongest Community currency or an 'inflation proof' supranational currency, but it cannot benefit the ecu since as a basket it cannot be better than the average. However, this effect would be limited to cash (and other non-interest-bearing instruments) since in efficient international capital markets expected changes in the exchange rate are reflected in the rate paid on interest-bearing assets. [30]

The parallel currency as a transaction medium

The most important obstacles to a widespread use of a parallel currency are the bid-ask spreads and similar conversion costs. For purely national transactions in the national retail and corporate sector there seems in general to be no reason to incur the additional cost of using the parallel currency. The only area where a parallel currency might be used for transaction purposes is therefore that of international commercial transactions where it would be convenient to use the parallel currency only if it constituted a convenient *vehicle currency*, that is if it was cheaper to make two transactions (national currency into parallel currency and parallel currency into other national currency) in the market for the parallel currency than one transaction in the market for national currencies. [31] This applies to transactions with agents from outside the Community as well.

It is often claimed that it would be enough to give *legal tender* status to the

[30] See Gros (1989d) for a more detailed discussion of the conditions under which inflation differentials can expected to lead to significant flight out of the national currency. Experience and some simple transactions costs considerations suggest that inflation differentials of about 20 to 30 % would be needed to trigger significant currency substitution.

[31] A vehicle currency arises because the interbank market for foreign exchange concentrates on a few major vehicle currencies; it is not active for all possible bilateral exchange rate combinations. However, it is to a certain extent arbitrary which currency becomes a vehicle currency since, once it has been chosen a such, it will also be cheaper to use because it will have a large market.

potential parallel currency to ensure its success as a transaction medium. [32] This idea therefore deserves some further discussion. Legal tender is defined as 'the mode of offering payment of a debt which a creditor is entitled to demand and in which a debtor alone is entitled to make payment'. [33] There is more than one way in which the parallel currency could become legal tender that would be compatible with this definition. The influence of this factor on the demand for the potential parallel currency would therefore depend on the details of how the legal tender status of the currency is organised.

One solution might be that it becomes legal tender for all contracts in which it is used to denominate payment obligations. It would thus be on the same legal footing as the domestic currency, obtaining a sort of 'most favoured currency' status. Compared to the current practice, which allows enforceable contracts in any currency for international transactions, this implies that the only effect of such a legal tender status would be to permit the use of the parallel currency also for purely domestic transactions. [34] Since for domestic transactions there seems to be no advantage to the use of a parallel currency, such a limited legal tender status would have no effect on the incentives to use the parallel currency.

A more effective legal tender status for the parallel currency would therefore be *preferential* legal tender, which would imply that the debtor could choose to settle obligations denominated in any national (Community) currency in the parallel currency (presumably the ecu) but not vice versa. [35] However, as long as exchange rates are not irrevocably fixed a preferential legal tender status would introduce an important element of uncertainty in all contracts denominated in a national currency. It would probably be necessary for the authorities to publish each day a conversion table which would determine how many units of the parallel currency would be equivalent to one unit of the national currency for legal tender purposes. If this rate is valid for the entire day, it is clear that there would be incentives for large operators to take advantage of intra-day exchange rate changes to pay in the currency that is cheaper on the market than for legal tender purposes.

[32] At present only the national currency is legal tender in all Community countries with the exception of Luxembourg where the Belgian Franc is also legal tender.

[33] See D. M. Walker, *Oxford Companion to Law*, Oxford, Clarendon Press, 1980 p. 755.

[34] Even at present it is possible to use balances denominated in one currency to pay contractual obligations denominated in another simply by exchanging the two national currencies on the market; the only difference a non-preferential legal tender status for a presumably supranational currency would make is that there would be no transaction cost (e.g. the bid-ask spread) for the agent making the payment.

[35] A historical example for a preferential legal tender status is the Vereinsmünze created by Vienna the Coin Treaty of 1857, see Holtfrerich (1989).

If the legal conversion rate is fixed with reference to some market rate the incentive to use the parallel currency or the national currency would vary from day to day and from currency to currency. If the legal conversion rate is fixed without reference to some market rate, Gresham's law would operate and only the currency that is cheaper on the market would be used.

As long as exchange rates are not fixed it would therefore be practically impossible to give any parallel currency a meaningful legal tender status going beyond the freedom to contract in any currency that will exist in the European Community by 1992 anyway.

ii) Competing currencies

A more radical variant of the approach that no institutional steps are needed would promote competition between national currencies as well. This seems to be the essence of the UK proposal published in 1989. [36] According to this document only stage I of the Delors plan should be implemented. After stage I competition among currencies would become operational and increasingly effective because capital-market liberalisation and the single market for financial services would increase the available financial instruments and services. The increased competition through the single market in financial services would contribute to this currency competition by reducing the cost and inconvenience of changing between Community currencies.

According to this approach the only policy action to be taken beyond stage I would be to eliminate all restrictions on the use of Community currencies and to tackle the remaining barriers between currencies, for example by promoting cheaper European cheque clearing systems and eliminating anti-competitive practices by banks in their charging for foreign exchange services.

It is apparent that these elements of the UK proposal could and should be part of the internal market programme in financial services. However, it is not clear from the UK document whether and how the competition between currencies would lead to a monetary union, in the conventional definition of a single currency. As argued in the preceding section it is unlikely that in the environment of low inflation and low exchange-rate variability which would be created by stage I, existing national currencies would be replaced either by a parallel currency or by the strongest Community currency. It is therefore highly unlikely that any further progress towards monetary union could be achieved by relying exclusively on currency competition through market forces.

[36] See 'An Evolutionary Approach to Economic and Monetary Union', HM Treasury, November 1989.

One might argue, however, as implicitly in the UK paper, that the present low and converging inflation rates are the result of a system that has encouraged competition between stability-oriented monetary policies. According to this argument it would be dangerous to create a new Community institution to coordinate national monetary policies because that would limit the extent of this competition. A Community institution might encourage an overall monetary policy stance closer to the average performance than to the best, progress towards price stability might therefore stop or even be reversed if competition between currencies (or more precisely between national monetary policies) is eliminated or reduced. This is the main reason why it would be preferable, according to the UK position, not to take the institutional steps towards a common monetary institution foreseen in stage II of the Delors Report.

The argument, however, that only competition between national monetary policies ensures price stability exaggerates the influence of currency competition and overlooks the difficulties in determining a stable anchor for prices and expectations that would arise in a stage I environment. Private markets do not always adopt the currency with the most stable purchasing power. The US dollar, for example, has not lost its position as the dominant international currency although it has on average over the last twenty years lost more of its purchasing power than the DM (and more recently the yen). The reason for this is again that there are economies of scale in the use of money. Stability of purchasing power is only one of determinants of the 'success' of a currency.

The most fundamental objection against the notion that only currency competition, at fixed exchange rates, ensures price stability is, however, that a fixed exchange rate system needs an anchor for prices and expectations. In the EMS this anchor has so far been provided by the monetary policy of the Bundesbank. The Bundesbank was able to perform this role mainly because it was always able to sterilise intra-EMS reserve flows. Up to now these flows were limited because the UK and Spain did not participate in the ERM and capital controls were effective in limiting capital flows in the short-run. However, in a stage I environment, with all currencies participating in the ERM, with capital controls eliminated and financial markets everywhere more sophisticated and liquid, the potential for reserve flows would exceed the sterilisation potential of the Bundesbank. This might jeopardise the anchor function of the Bundesbank. The increasing integration of financial markets and wider ERM membership therefore represent no guarantee of a good price stability record; on the contrary, they might endanger it.

Another conceptual problem inherent in the UK approach is that it aims at making Community currencies increasingly substitutable. Progress towards monetary union would come through currency substitution, but widespread currency substitution would make national monetary policies less reliable and threaten the anchor role of the DM in the EMS. If there is really widespread currency substitution a common monetary institution would definitely be needed. In this sense significant progress under the market-led approaches, whether the parallel currency approach focussing on the ecu or the UK proposal, would create a need for institutional steps.

2. The institutional approach: the stages of the Delors Report

The Delors Committee was asked by the European Council to 'study and propose concrete stages leading towards this union' (i.e. EMU). [37] Its report envisages three stages in this process. A first stage would reinforce voluntary cooperation in both the monetary and the budgetary areas and conclude negotiations for the Treaty changes required to move beyond the first stage. The second stage would start with the ratification of the Treaty revisions; some economic policy functions would begin to be centralised and a new European System of Central Banks would start operations in limited policy functions. As in stage I, realignments would not be excluded, though they would be very infrequent; in that sense ultimate authority even over monetary policy would remain in national hands - hence the term 'soft' union. At the start of stage III exchange rates would be irrevocably fixed and monetary authority fully centralised in the ESCB; 'binding rules' could be applied to national budget deficits. The introduction of a common currency should follow soon thereafter.

Since the final version of EMU has already been analysed in Part One of this paper, we confine our comments on the third stage to the prime institutional aspect of the role and structure of the ESCB. We begin with a discussion of stage I, which may not seem to merit the label 'institutional' since it marks an effort to go as far as possible in policy coordination without introducing Treaty changes; but it is supposed to produce the necessary proposals for such changes. A brief review of the main features of stage I as an evolution of the present EMS may also serve as an introduction to our later discussion on the limits of voluntary coordination. We try to point out through some examples, taken from the individual contributions to the Delors Report, in what respects monetary authority would with advantage be centralised. This is followed by a discussion of stage II which presents the most interesting analytical issues since it lies between two systems whose economics are better understood.

[37] Conclusions of the Hanover European Council, 27-28 June 1988 as reprinted in *Delors Report*, Annex 1, p. 43.

i) Stage I: tighter voluntary coordination

Stage I caused few objections when the Delors Report was on the agendas of the European Council in Madrid in June and the ECOFIN Council informal meeting in September. Stage I will start on July 1, 1990 - the latest date set for it in the Delors Report - while no date has yet been agreed for its completion. What are the main new features of this stage and are they likely to be adequate to the tasks?

There appear to be three new features, all surrounded by some uncertainty as to the significance of their impact on policy coordination as it exists in today's EMS:

(1) New procedures for coordination in the Committee of Central Bank Governors and the ECOFIN Council;

(2) Participation of all currencies in the EMS in the course of stage I; and

(3) Experimentation with some of the procedures under negotiation for subsequent stages towards EMU.

(1) has in principle been clarified by the Decision of ECOFIN on 13 November, 1989, to replace the 1964 Council Decision defining the mandate of the Committee of Central Bank Governors and the 1974 Council Decision on economic convergence by new Decisions guiding the form and substance of the efforts at policy coordination by central banks and in the ECOFIN Council.

The new Decisions which follow closely the proposals in the Delors Report (paras. 51-52) are difficult to evaluate, because everything depends on how the two EC bodies will make use of their mandate; those of 1964 and 1974 were never used fully. Taken literally, the Governors' Committee would from next summer develop both a more visible public profile and strengthen its analytical capacity and sub-committee structure with a view to developing an *ex ante* approach to, rather than an *ex post* analysis of monetary coordination. This would be a significant change, but it remains to be seen to what extent the Governors would actually wish to speak up in their new reports to the European Council and the European Parliament, or in collective opinions on policies in individual countries or by the EMS participants as a whole. Discussions in the Delors Committee in fact suggested that the scope for moving voluntarily, i.e. without institutional change, towards genuine *ex ante* coordination is likely to be severely circumscribed.

The Delors Committee conducted a small questionnaire study among EC central banks to clarify the scope for moving ahead without Treaty changes. Crudely summarised, the smaller participants did not see major problems in going further in the direction of submitting the policy formulations and decisions to *ex ante* coordination within the Committee of Governors; the smaller countries have few illusions of monetary autonomy left. But several of the larger countries did not see any possibility of moving significantly further without important changes in national monetary legislation and in the Treaty. The reason is either that national monetary authority is today divided between the central bank and the political authorities, with the latter unwilling to delegate to an unspecified process of central bank coordination, or that the central bank itself has an elaborate decision-making structure which makes it very difficult to conceive that it could delegate, through its President or other participants in the coordination procedures, even non-binding competence to a European body. The former of these two situations corresponds roughly to the set-up in France, and - presumably *a fortiori* - in the United Kingdom, when sterling joins, and the latter of that in the Federal Republic of Germany. From the perspective of either of these situations there is a need for something more well-defined than voluntary cooperation to put at the centre before genuine change can be expected.

This conclusion is reinforced if one looks at recent trends in the EMS. It is today conventional wisdom, shared in most academic research and in official circles, that the EMS has come to operate, following an initial four-year period of policy divergence and sizeable realignments, as an asymmetrical system, with the Bundesbank largely exercising the residual degree of freedom available to a group of countries within a fixed exchange rate system, viz. to set implicitly, through its pursuit of a domestic monetary objective, the inflation rate for the system as a whole. In an earlier CEPS publication we argued that such an evolution was inevitable as anti-inflationary preferences intensified throughout Europe, and that it would be beneficial for other participants to maintain it, as long as the anti-inflationary credentials of the Bundesbank were stronger than those of other participants and governments in the system. [38] While this condition continues to be met, it is increasingly open to question whether the EMS still functions as an asymmetric system with German leadership. The observation that it is visibly the Bundesbank which operates as a price leader in interest-rate adjustments, readily followed by most other participants with a minimal delay, is not in itself evidence of preservation of the status quo.

The emerging alternative view [39] would say that monetary leadership is already becoming widely shared in the present transitory phase where exchange rates have become rigid and markets begin to have confidence in their perpetuation. Currencies that used to be considered weak are experiencing massive inflows

[38] See notably Gros and Thygesen (1988), pp. 20-23 and 45-46.

[39] Clearly expressed in Giavazzi and Spaventa (1989).

of funds, as market participants take advantage of the large interest differentials in their favour. The so-called weak-currency countries are reacting by some appreciation of their currency inside the EMS-band, while they try to sterilise most of the inflows in order not to stimulate demand in their already rapidly-expanding economies. The Bundesbank, on its side, has been trying to sterilise the outflows from Germany while occasionally raising short-term interest rates. The latter move serves to dampen domestic demand and inflation - traditional concerns of the Bundesbank - but they should also be seen as steps to ease tensions in the EMS. To the extent that they substitute for restrictive policy actions, notably on budgetary policy, in some of the partner countries, these increases in short-term interest rates cannot be interpreted solely as evidence of traditional German leadership. In particular, the nominal anchor function of German monetary policy is becoming less prominent.

In summary: a system in which the low-inflation centre country has pursued a domestic monetary target, while partners have pegged themselves to its currency and sterilised outflows only moderately, has imparted a disinflationary trend to the system as a whole, but the recent working of the system in which flows on average have often been in the opposite direction, and all countries sterilised their interventions more fully, implies some inflationary bias and requires much more explicit coordination, preferably ranging beyond the monetary area. This is particularly essential if, as observation suggests, most participants are not prepared to make use of realignments. [40] The present EMS and the procedures to be put into operation in stage I appear too weak and informal to tackle the required rethinking of adjustment mechanisms in a more symmetrical system. This will become more evident as residual restrictions on capital flows are removed in 1990 in France and Italy (and in 1992 in Spain and Ireland).

(2) The participation of additional currencies in the EMS will intensify the need for procedures going beyond voluntary coordination. The entry of the Spanish peseta in June 1989 has already provided additional illustration of the need for more explicit coordination as the EMS moves towards a more symmetrical system. The participation of sterling from some point during stage I will improve confidence in the UK currency and - provided that sterling interest rates remain higher than DM interest rates - lead to sizeable outflows from Germany to the UK. This flow will not be welcome given the already highly liquid state of the British

[40] The President of the Bundesbank and some leading politicians in Germany have openly suggested that realignments would be appropriate. It is difficult to see, however, what purpose they would serve without policy coordination, though the creation of some additional exchange rate uncertainty might bring temporary relief.

economy; it will at some point be interrupted and reversed, as anticipations of a realignment arise. Given (i) the long British tradition of using monetary policies in an activist way for domestic stabilisation, and (ii) the precarious state of the UK current account, markets would be justified in assuming that the EMS will be in for a rougher ride in the next few years than, say, in the 1987-89 period. The system could come to look more like the view of it presented in Walters (1986) or in other unstable models of economic interaction between countries where inflation and nominal interest rates have not converged closely and discrete realignments can still occur.

In such a world capital flows can be destabilising, by flowing towards the higher inflation (and interest-rate) country, hence perpetuating inflation differentials, and by generating massive outflows prior to realignments followed by a reversal. We have in the past regarded such a view as an unduly pessimistic, indeed as a caricatural, perspective of the EMS, because the present members have tended to orient their monetary policies strongly towards cohesion in the system, and they have managed some realignments smoothly. This relatively successful experience cannot be taken for granted in a stage I with enlarged membership without efforts to go beyond voluntary coordination.

In short, the enlargement of membership makes it more, not less, urgent to move beyond stage I toward an EMU with irrevocably-fixed exchange rates, virtually complete convergence of interest rates and centralisation of monetary management. [41] Far from causing offence among present EMS participants, labelling the system 'a half-baked house' prompts relevant reflection on how the EMS might be strengthened to accommodate sterling too. Improving coordination beyond the voluntary should also be a British priority, though the UK official view is, quite naturally, that EMS membership (as it is at present) would be such an economically and politically demanding step that nothing more is required in the short term. [42]

(3) The third new feature of stage I is that an intergovernmental conference will be convened 'once the first stage has started', to consider the revisions of the Treaty required to move beyond the first stage, provided that 'full and adequate preparations' for such a conference have taken place. During the French EC presidency in the second half of 1989 a high level *ad hoc* group, composed of those officials in the national Treasuries and Foreign Ministries who will be the main advisers

[41] This point is also made forcefully in Matthes (1988).

[42] For a forceful expression of this view, see H.M. Treasury (1989). Some UK observers, however, broadly share the concern of the present paper over instability in the first stage, see e.g. Goodhart (1989).

to governments during the Treaty negotiations, prepared a preliminary list of the main questions on EMU to be settled at the intergovernmental conference. Whether this report constitutes 'full and adequate preparations' may be open to question; such preparations will accelerate only when a date for the conference is set. Partly for this reason the prevailing opinion in most countries now appears to favour the setting of a date in the second half of 1990, i.e. almost concurrent with the start of stage I. The momentum of the process recommended in the Delors Report (paras. 64-66) has been retained; the intergovernmental conference will be the main new feature of stage I, justifying a view of this first stage as a period for deciding upon change, rather than a qualitative change in itself.

Once the intergovernmental conference is convened, and detailed proposals are made on further stages towards EMU, to be embodied in a revised Treaty, there may, however, be a feed-back upon the first stage. Those countries least ready to envisage early Treaty revision may become the most anxious to demonstrate that voluntary coordination replicating the mandatory procedures proposed for subsequent stages can do as well as a reformed system. [43] A constructive feedback process may start which has been absent in the present EMS as long as there was no prospect (or threat) of institutional change. Such a projection into the practices of stage I of ideas for later full and mandatory coordination would obviously be unobjectionable. If successful, the process would contradict the prediction made above that the first two features of stage I - growing *de facto* symmetry and a risk of increasing instability upon enlargement - make it unlikely that the system could qualitatively improve or even retain its stability without institutional change. Our basic assumption is therefore that preparations should be made for the eventuality that stage I might not be stable and that the alternative, non-institutional approach proposed by the advocates of decentralisation and competition between national monetary performances which we discuss in the previous section does not constitute a promising alternative. Stage I should accordingly be as short as possible, i.e. as long as it takes to negotiate and ratify a revised Treaty. But whether there will actually be a move beyond stage I depends on the specific proposals for stage II.

ii) Stage II: 'soft' union and an emerging central bank

Why is an intermediate stage between the tighter, still voluntary, cooperation of stage I and the irrevocable locking of exchange rates, followed by the introduction

[43] Some statements by officials of the Bundesbank and the Netherlands Bank comment on the first stage in this spirit, see e.g. Pöhl (1989) pp. 146 ff, and Szasz (1989).

of a common currency, desirable or even necessary? Would it not be possible simply to extend stage I until this final step were seen by all participants as feasible?

It seems to us highly unlikely that three elements necessary for the transition to irrevocably-fixed exchange rates and a collectively-managed monetary policy through a European System of Central Banks, could emerge without such an intermediate stage. They are (i) a consensus on the specific formulation of the ultimate objective(s), (ii) a common analytical framework for intermediate objectives and for the design of monetary policy; and (iii) a sufficient degree of experience with common operations. These three elements are part of a learning process in the absence of which we would doubt whether the final step could be taken. We accordingly subscribe to the view of the Delors Report that an intermediate, but not necessarily long, stage is required. In particular, experience in genuine joint decision-making is desirable, before monetary authority is fully centralised in the final stage.

It would be easier in some respects, if such an intermediate stage could be skipped, because the division of responsibility between the national central banks and an emerging ESCB is complex. A clear attribution of responsibilities assuming the cohesiveness of the system is therefore essential.

The Delors Report refrained from presenting a detailed blueprint of the intermediate stage, 'as this (transition) would depend on the effectiveness of the policy coordination achieved during the first stage, on the provisions of the Treaty, and on the decisions to be taken by the new institutions.' (para. 57). Nevertheless, some preliminary ideas are offered, and some of them are elaborated in papers contributed to the work of the Committee in their individual capacity. With preparations for the intergovernmental conference accelerating, there is an urgent need to examine how the intermediate stage can provide a framework for the learning process. [44]

It is to us evident that once exchange rates have been irrevocably locked at the transition to the final stage of EMU, a common monetary policy is required and will have to be formulated collectively by the governing bodies of the ESCB. In contrast, during stage II when realignments and fluctuations inside the bands may still occur, national authorities will retain the final word concerning their exchange rates and hence their monetary policies. But the same considerations that lead to the conclusion that the final locking of parities requires a common monetary policy also imply that to the extent that exchange rates become *de facto* stabilised, and recognised to be unlikely to change, national monetary policies

[44] The following draws heavily on Thygesen (1989b), which is an elaboration of one of the author's contributions to the Collected Papers for the Delors Report, Thygesen (1989a).

will, de facto, become ever more severely constrained. Increasing exchange-rate stability therefore requires a framework for cooperation and coordination of national monetary policies. The more explicit the degree of exchange-rate fixity, and the higher the degree of capital mobility, the closer must be the coordination and the extent to which the overall policy stance of the participants has to be decided in common.

In his contribution to the Collection of Papers Lamfalussy (1989) refers to three possible approaches in stage II. The first is for the participating central banks to set up a jointly-owned subsidiary, whose facilities they would share in performing certain of their functions - notably the implementation of monetary policy through the domestic money and foreign exchange markets - without requiring any formal transfer of authority. The second is to assign a small number of monetary instruments to the ESCB while leaving others for national decisions or non-binding coordination. The third is to implement a gradual but formal transfer of decision-making power from the national to the ESCB-level. The three approaches may perhaps be labelled pooling of (1) operations, (2) instruments and (3) authority.

The three approaches appear to be complementary rather than mutually exclusive. Indeed, (2) and (3) are difficult to distinguish, since both, in order to be effective, would require the introduction of some hierarchical order in the relations of the ESCB governing bodies and the constituent national monetary authorities. They will be treated as a combined approach in the following. (1), however, is different in requiring no formal transfer of authority; in that sense it could be pursued or prepared already in stage I, particularly if the more detailed design of the other two approaches proves time-consuming to negotiate.

The pooling of operations would consist in the establishment of a common operations facility incorporating all of their foreign exchange and domestic money market activities in a jointly-owned subsidiary. Each central bank would staff its own operations, but at some point the initially-seconded national staffs could be merged into a single unit. The use of common facilities would make the operations of each individual participant fully transparent to other participants - a state of affairs not realised to-day with respect to the management of foreign exchange reserves apart from interventions proper or to domestic money market operations - while at the same time presenting a common appearance in the markets. Private market participants would be unable to determine the source of instructions for operations by the jointly-owned agency. There could no longer be occasionally-conflicting signals to the markets.

To these two general advantages one may add that centralisation of operations would provide a more efficient training ground for national foreign exchange and money market operators than the incomplete and necessarily short concertations by telephone in today's system. The approach would facilitate efforts to develop a more convergent framework for the design and implementation of monetary policy, including the domestic aspects of the latter, and hence prepare for the fully joint management in stage II. Centralisation may also offer some potential for cost savings.

Despite all these virtues - and the prospect of postponing the need for Treaty revision which it offers - the pooling of operations in itself could prove too limited an objective. Operations would be merely an aggregate of the instructions received with no one visibly in change of the consistency of policy over time - or of preventing actions at cross purposes within any period of time. The approach would therefore need to be complemented by the two other approaches in the course of stage II. To implement either of them would, however, require some consensus about the objectives - ultimate and intermediate - and the design of monetary policy and use of instruments which cannot be said to exist today, at least in any explicit form. The following pages address these three issues in a highly preliminary way, mindful that they require very substantial efforts of macroeconomic analysis, study of empirical regularities and assessment of practical feasibility in order to be meaningfully discussed.

How could the general mandate for the ESCB, i.e. to aim for price stability, be made concrete in collective terms for the Community as well as nationally so that both the aggregate thrust of policy and the compatibility of the national components can become subject to monitoring? Since stage II would be replacing a well-functioning EMS in which anti-inflationary credentials have been laboriously acquired, it is particularly important to give attention to a fairly specific formulation of the price objective. A natural candidate might be to aim for stability in average producer-prices in the internal market. A price index of this kind would, as the process of integration and competition advances, provide an increasingly reliable indication of a common price trend. Such an objective could be said to be a logical complement to the construction of the unified market. If it were accepted that external price shocks, such as major changes in the prices of energy or other important imparts, should be in part accommodated through monetary policy adjustments, one could focus on the domestic (i.e. internal to the EC) sources of inflation for which the ESCB would be more directly accountable. A deflator of value added in manufacturing industry, calculated as a weighted average for the internal market, would leave out of account externally generated price shocks.

It is less clear to what extent such a collective objective would need to be underpinned by national nominal objectives, such as nominal income or fiscal

demand, and by intermediate objectives. There must be a strong presumption that it would be hazardous to gear monetary instruments assigned to the ESCB directly to a relatively remote objective such as average price stability. On the other hand, there will be much uncertainty for a lengthy initial period as to what degree of national dispersion around the average is compatible with the emerging fixed exchange rate system; and it will become increasingly difficult to give a precise interpretation to national intermediate objectives in the form of domestic credit expansion (DCE) in each participating country as financial integration progresses. Largely for the reasons advanced first by Russo and Tallio (1988) there would appear to be good analytical reasons for developing a framework in which national DCEs, coupled with a general presumption against sterilisation of interventions vis-à-vis other participating currencies, provide the main underpinning for monitoring national contributions to the collective monetary policy. The setting of national DCE targets would in turn be guided by nominal income, or final demand, objectives compatible with the average price target.

Such an emphasis on quantities may seem outdated at a time when most monetary aggregates are becoming blurred. Monetary institutions committed to price stability are always faced with a choice between a supply rule constraining the quantity of money issued to a slow rate of non-inflationary growth and a convertibility rule which assures holders of money that they can acquire at a fixed rate an asset with attractive qualities in future exchanges against goods, see e.g. Leijonhufvud (1983). The régime here envisaged for the ESCB would contain elements of both systems; as there is no external reserve asset, convertibility into which could assure a high degree of confidence in the future purchasing power of national monies - such as gold in the pre-1914 period and the US dollar in the Bretton Woods period - some reliance on a quantitative supply rule at the collective level seems unavoidable, despite the conceptual and practical problems it raises. However, a supply rule alone would be too weak in the new framework, marked by a growing commitment to EMU and to full financial integration. It would be hard to know *a priori*, i.e. until some experience within the new framework as to the demand for money and credit has been gained, whether a particular DCE-target (or target range) was just the appropriate one. Hence the explicit price objective - though without any convertibility provisions into the basket of goods chosen for the price objective - besides some quantity rules.

The Delors Report does not envisage any significant commitment for the ESCB to stabilise participating currencies against third currencies. To the extent that net interventions in dollars or other third currencies are undertaken by the participants, there will be a divergence between total money creation and the sum of national DCEs which would have to be taken into account in setting objectives for the subsequent periods. Therefore, most interventions in dollars or in other third currencies should not greatly upset the controls over aggregate money creation through the sum of domestic credit expansion in the participating economies. If such interventions were to be substantial in any one period they should be subject to commonly agreed guidelines and allowed for in setting the DCE-targets for the subsequent period (see the discussion of instrument policy below).

For the individual central bank the main operational objective in stage II would be to maintain in a credible way stable exchange rates vis-à-vis other participating currencies. *Ex ante* coordination of DCE objectives should make that task easier on average; in practice, the DCE objective may, in particular situations, have to be overridden to maintain shorter-term exchange-rate stability.

Collective formulation of ultimate and intermediate monetary objectives would in itself constitute a major step towards *ex ante* coordination. The participating central banks would deepen their exchange of information on their respective formulations of monetary policy by giving the reports prepared for them a more explicitly common analytical framework and by formulating joint intervention strategies and guidelines for DCE rather than simply reviewing the past record. Closer coordination could begin even while the guidelines emerging from it are not mandatory, to replicate the effects of a more advanced stage; in principle, this process begins already during stage I.

Yet it is unlikely that anything resembling closely a common monetary policy could be conducted merely through discussions, but without vesting in the ESCB genuine decision-making powers with respect to at least some significant instruments of monetary policy. Indeed, that is the rationale of suggesting the setting of the ESCB for stage II before the irrevocable locking of parities which makes a common monetary policy a simple necessity. But there are difficulties in determining how monetary authority might be shared between a centre - the ESCB Council and Board - and the participating national central banks. The efficiency of operations requires that there should never be any doubt in the financial markets, among national policy makers or elsewhere as to which body has the responsibility for taking particular decisions. Monetary authority is less easily divisible than budgetary authority where elements of decentralisation and even of competitive behaviour between different levels of government, or within the same level, may be observed in national states.

Three types of policy decisions could be considered as being at the core of any design of a workable pooling of instruments or responsibilities within an ESCB in stage II:

(1) adjustment of short-term interest differentials;

(2) intervention policy vis-à-vis third currencies;

(3) changes in reserve requirements.

We do not recommend that a potential fourth instrument, namely realignments, be assigned to the ESCB. This is discussed in more detail below.

(1) Short-term interest differentials

Adjustments of relative short-term interest rates constitute the central instrument in managing the present EMS and the main candidate for gradual pooling of authority. A high degree of coordination and occasionally *de facto* joint, or at least bilateral, decisions have been observed. Participants have developed, particularly since the so-called Basle-Nyborg Agreement of September 1987, a flexible set of instruments for containing incipient exchange-market tensions: inframarginal intervention, wider use of the fluctuation band, and changes in short-term interest rate differentials. This combination has proved fairly robust in most periods of tension since September 1 1987. But a risk remains that the experience of earlier periods of tension will be repeated; then public criticism and mutual recrimination between Ministers of Finance occasionally intensified tensions and made monetary management very difficult. The main examples of such episodes are December 1986 - January 1987, November 1987 and - to a minor extent - April 1989. The participation of additional currencies in the EMS in the course of stage I, notably sterling, which has traditionally been managed with considerable involvement on the part of the UK Treasury and even of the Prime Minister, will make it urgent to strengthen procedures for genuine coordination further and to make the transition to a more joint form of management in stage II at an early stage.

Decision-making in this sensitive area would still remain in national hands in stage II, but the launching of the ESCB at the beginning of stage II would in itself imply that national governments become less likely than in the past to involve themselves directly in the management of exchange crises. In the course of stage I the Committee of Central Bank Governors may already have begun to perform more efficiently the role of multilateral arbitrator that has been missing occasionally in the past. A common analytical framework for the intermediate targets as outlined above would give more explicit guidance as to who should adjust to whom. If the proposal to develop a joint operational facility for exchange and money market operations is pursued, that would in itself bring participating central banks into more continuous contact also with respect to their transactions in their domestic financial markets and facilitate coordinated action on interest rates.

The gradual and partial upgrading of decision-making on relative interest-rate adjustment from the purely national level to a Community body, in the first stage the Committee of Governors, from the second stage the ESCB Council, will not in itself assure that the average level of interest rates in the participating countries is appropriate, though it should tend to make such an outcome more likely than the present system with its occasional inefficiencies of interest-rate escalations and tensions. To get a firmer grip on the average level of rates, the attribution to the ESCB of an instrument which permits a collective influence on domestic sources of money creation would be necessary. Such an instrument is described briefly below in the form of the ability for the ESCB to impose compulsory reserve requirements on domestic money creation and to develop gradually a market for a European reserve base with its own lending rate.

(2) Intervention policy vis-à-vis third currencies

A second instrument for which some degree of joint management could be envisaged is *foreign exchange interventions in third currencies*. There are two potential arguments for developing a joint policy: (1) the medium-term need to contribute to the containment of major misalignments and (2) the smoothing-out of short-term volatility vis-à-vis third currencies.

The former argument can hardly be assessed without making a judgment on the feasibility of a more managed global exchange-rate system and the degree of commitment by other major monetary authorities, notably in the United States, to support, through intervention and domestic monetary adjustment, any understanding reached on the appropriate level of the main bilateral exchange rates. Given the experience of the period since 1977 and the major present current-account imbalances, projected to persist well into the 1990s, it would be hazardous to assume that an emerging joint dollar policy of the EMS countries would be anything more than *ad hoc* guidelines for managing a collective appreciation of the EMS currencies as smoothly as possible. Calculations with large macroeconometric models suggest that the appreciation may have to be at least in the order of 20 % in real terms on average for the EMS currencies from the levels prevailing in mid-1989, if the European countries are to assume a reasonable share of the adjustment of the US current deficit to a sustainable low level (see notably Cline, 1989). This will put the cohesion of the EMS currencies to a severe test, but it will also provide a unique opportunity, as was the case in 1985-87, for reconciling low inflation in Europe with a relatively expansionary monetary policy in the Community, hence contributing to an improved and satisfactory price performance in the transition period from the present more decentralised operation towards economic and monetary union.

As regards the task of smoothing-out short-term volatility, it must be noted that tensions between EMS-currencies have often in the past decade been triggered by financial disturbances from third currencies, notably movements in the dollar. The currencies participating in the EMS were seen by the markets as being sensitive in different degrees to such disturbances. These perceived differences had their origins in varying degrees of controls on capital movements and in expectations of the likelihood of divergent policy reactions to the external financial disturbances. For example, a depreciation of the dollar was normally expected to strengthen the DM relative to most other EMS-currencies, because (1) the DM had a far larger domestic financial base and the most liberal regime for capital flows, and (2) the non-German authorities in the EMS were seen as more prone than the Bundesbank to try to avoid the contractionary effects of the appreciation of their currencies. The tensions to which these - real or perceived - differences in structure and/or behaviour gave rise were occasionally mitigated by an EMS-realignment. Conversely, in periods of an appreciating dollar, outflows from Europe were observed to be particularly strong from the DM-area, reflecting closer substitutability between the US dollar and the DM than that prevailing for other EMS-currencies, but presumably also a perception of decreasing probability of a realignment within the system. In recent years the liberalisation of capital movements in France and Italy and in some smaller EMS-countries, the deepening of continental European financial markets and the improved cohesion of the EMS economies have all contributed to a weakening of the earlier negative correlation between movements in the US dollar (in effective exchange rate terms) and movements in non-DM currencies in the EMS vis-à-vis the DM (as shown e.g. by Giavazzi and Giovannini, 1989). But the tendency for dollar movements to affect the EMS-currencies differentially may be expected to persist in moderate form into stage II. The task remains in that case to avoid such tensions (if unwarranted by more fundamental economic divergence) persisting and forcing realignments.

While this could in principle be achieved through joint guidelines for essentially decentralised interventions by the participating national central banks, a visible capacity to intervene jointly in third currencies, and to do so in ways that further the cohesion of the EMS, is potentially important. Without a presence in the major exchange markets the ESCB would lack the capacity to check the impact of external financial disturbances on EMS stability at source. Hence 'a certain amount of reserve pooling' (Report, para. 57) as well as ample working balances in EMS-currencies would be desirable in stage II.

It is impossible to determine a priori what percentage of external official reserves would have to be pooled in order to create a credibility effect in the financial markets for an emerging joint intervention policy. Leaving the percentage low, say 10-20 %, as proposed by some members of the Delors Committee as a possible step in stage I (para. 53), might run the risk of complicating existing cooperative procedures without making a qualitative difference, though even with limited pooling some beneficial effects could be expected from the learning experience of coordinating interventions through the same trading floor (see also de Larosière, 1989). And pooling reserves would have the clear advantage over pooling operations in that it would force the participants to formulate guidelines for intervention.

Joint intervention in third currencies by means of pooling of part of exchange reserves did not win general favour in the Report as a proposal for the first stage; 'too much emphasis might be put on external considerations relative to the correction of imbalances within the Community' (para. 54). This argument would not apply to an ESCB capacity to intervene in stage II along with the attribution of other monetary instruments with more direct domestic implications for the participants as proposed here.

(3) Reserve requirements

A third instrument, specifically assigned to the ESCB, would be the ability to impose *variable reserve requirements* on domestic money creation.

Whereas the first two instruments (and the fourth to be discussed below) are directed primarily at relative adjustments within the EMS, changes in required reserve ratios affect the overall thrust of monetary policy. International monetary agreements, including the Bretton Woods system and the EMS, have typically been more explicit on relative than on aggregate adjustment in the participating countries. The EMS procedures for relative adjustment may leave something to be desired, as explained above, and also leave too much discretion to national monetary authorities to remove ambiguities and tensions. Yet more attention has been given to these procedures than to discussion of whether monetary policy has an appropriate aggregate thrust.

The Bretton Woods system and the early EMS did not have to face up to this issue directly, because both systems were protected by a mixture of capital controls for the short term and some scope for changing the exchange rate in the longer term. The post-1983 EMS has had more difficulty in avoiding the issue. In the absence of some aggregate monetary target for the whole system, an implicit monetary rule has emerged: monetary policy in all participating countries has tended to be determined via the ambition to hold more rigidly fixed nominal exchange rates, mainly by that of its largest and least-inflationary participant. The practice in the EMS that reserves used for intervention in defending a weak currency have to be reconstituted within the span of a few months is that convergence - provided that exchange rates do remain fixed - will be towards the low inflation in the Federal Republic of Germany and not towards some average as would be the case if intervention credits provided a more permanent safety net. In the latter event, efforts at 'sterilisation' would have become more widespread in the weaker currency countries, and aggregate money creation could have drifted upwards.

By using the degree of freedom of aggregate monetary policy for implicitly attaching policies to the domestic monetary target in Germany, the EMS has succeeded since 1983 to an unexpected degree in becoming 'a zone of monetary stability' in the double sense of promoting both exchange rate and price stability (as argued in Gros and Thygesen, 1988). The challenge for stage II (and stage III) is to design intermediate objectives and monetary instruments so as to make an extension of these features likely. The pooling of authority with respect to an instrument enabling the ESCB to influence domestic sources of money creation in each participating country would be the prime example of the third approach referred to above.

A major reason why the past system would in any case have to be revised is that the hegemonic role of the largest country already shows signs of weakening and could be expected to be eroded further during stage I, as additional currencies join the EMS and short-term capital transactions are fully liberalised. This process affects the size of potential flows in the new member countries, in those countries that will undertake additional liberalisation, notably France and Italy, and in Germany itself. The ability of the Bundesbank to keep a preferred domestic monetary target as close to a desired path as has typically been the case for the past 15 years must be expected to weaken further. Financial integration increases the risk of policy errors and hence the incentive for all participants to modify the present paradigm. Another factor working in the same direction is the increasing ease, as the credibility of fixed exchange rates becomes better-founded, with which all non-German participants can attract inflows of capital by maintaining short-term rates only moderately above those in Germany. The improved substitutability between participating currencies inexorably pushes the thinking of all monetary authorities in the direction of aggregate money creation in the area and to the formulation of intermediate objectives for domestic money creation consistent with an aggregate target and, finally, to designing procedures whereby the latter can be kept roughly on their agreed course; Ciampi (1989) provides an analysis of the options available. [45]

The essential feature is that the ESCB should be empowered to impose uniform or differentiated reserve requirements on either the increase in the monetary liabilities of each national central bank or on the credit extended by the member banks to their respective domestic sectors. This requirement would be met only by holding reserves with the ESCB; and the supply of reserves would be entirely controlled by the latter through allocations of a reserve asset (official ECUs) to each central bank corresponding to the demand for reserves which would arise, if agreed targets for money creation or DCE were observed. Both cost and availability considerations would provide central banks with an incentive to stay close to declared objectives. The ESCB would have to be given some discretion in extending or withdrawing reserves to provide marginal accommodation. The new system could largely replace the present method of creating official ECUs through temporary swaps of one fifth of gold and dollar reserves as well as the credits extended through the Very Short-Term Facility of the European Fund for Monetary Cooperation.

The system would create a monetary control mechanism analogous to that through which national central banks, who use reserve requirements, influence money and credit creation through their banking systems. It would introduce a certain hierarchy into the relationship between the ESCB and its constituent national central banks, while leaving some freedom for each national central bank in designing its domestic instruments.

The reserve requirements might alternatively be applied directly to DCE in the total national banking system, i.e. on the domestic sources of broad money creation. The advantage of this method would be to assign the collective monetary instrument more directly to a natural intermediate objective - DCE - underpinning fixed exchange rates, but it might introduce more slack into the control mechanism, as it would no longer apply to items that appear on the balance sheet of the central banks for which the latter could be regarded as more directly responsible.

A different approach that would allow the ESCB to have some direct impact on conditions in the financial markets could be pursued by imposing a uniform European reserve requirement on *commercial bank deposits* or on increases thereof. [46] Under this variant all community commercial banks would have to hold a certain small fraction of their deposits as compulsory reserves with the

[45] The following two paragraphs merely restate the main principles of the scheme, while the rest of the present subsection enlarges on it.

[46] See Gros (1989c) for more details.

central monetary institution. The only asset that could be used to satisfy this reserve requirement would be 'federal funds' which could be denominated in ecu.

The aggregate supply of these federal funds would be strictly under the control of the ESCB, since that would be the only institution that could issue them. The distribution of the total across countries and banks would be left to a federal funds market where commercial banks could trade among themselves the deposits with the central monetary institution which they need to satisfy the European reserve requirement. This scheme would therefore work like national reserve requirements, but on a European scale. The European reserve requirement could therefore be in addition to and independent of national reserve requirements.

This approach would imply that the ESCB would intervene directly in a market that reflects system-wide liquidity conditions. This might be preferable if the task of the ESCB is to be concerned with overall conditions as opposed to the specific conditions in national markets. In order to ensure a gradual transfer of authority from the national to the Community level it might be useful to impose initial limits on the total amount of open market transactions the central monetary institution would be allowed to undertake within a given period. These limits could be gradually relaxed in the course of stage II.

This approach could be implemented by giving the ESCB the power to impose a compulsory reserve requirement on all deposits of Community residents with Community commercial banks. To give banks access to deposits with the ESCB the latter could initially buy the appropriate amount of securities in the market. These securities could be denominated either in ecu, or in national currencies, provided the proportion of the different national currencies correspond to the ecu weights. Once the initial amount of federal funds has been created the ESCB could regulate the total amount of federal funds in the system simply by additional open market purchases or sales.

Through its open market conditions the ESCB would be able to directly influence overall liquidity conditions in the system. If it makes an open market sale, reducing the total amount available, commercial banks everywhere in the Community would tend to restrict their deposits because the interest rate on the federal funds market would rise. By limiting the total amount of federal funds that the ESCB makes available to the system it would always be in a position to limit total liquidity creation.

This approach would be compatible with different operating procedures for the ESCB. For example, it could choose an interest rate target and restrict the supply of federal funds whenever the actual ecu or federal funds interest rate fall below the target and vice versa if interest rates go above the target. But it could also target the quantity of federal funds by not intervening in the federal funds market and letting the interest rate adjust to bring supply and demand into equilibrium.

Different operating procedures would presumably be appropriate for stages II and III, but the mechanism in itself would not have to be modified for the passage to stage III. The subsequent evolution of the system would then be gradual and could lead to a smooth passage to the final stage without additional substantial institutional changes.

Suggesting some form of reserve requirements as the major instrument for an emerging joint policy to influence the domestic sources of money creation - as a complement to the control over the external sources which a joint exchange rate and intervention policy vis-à-vis third currencies would provide - is bound to raise critical questions. Although reserve requirements have historically been the prime method by which central banks have achieved monetary control in most countries, reliance on that instrument may appear to be limited in the Community today (see e.g. the survey by Kneeshaw and van den Bergh, 1989). In most industrial countries the banking system has become indebted to the central bank to an extent that makes it dependent on the terms on which marginal accommodation of reserve needs is provided. The mechanisms suggested illustrate ways in which an analogous influence may be brought to bear through a reserve requirement system either on the relationship between the ESCB and the participating central banks or more directly on commercial banks and financial markets in general. A direct contact between the central institution and financial market would provide a smooth passage to the final stage when the ESCB is to manage a common currency.

In summary, the attribution of the three instruments mentioned to the ESCB would constitute a comprehensive package which would enable the new collective body to exert significant monetary authority, while leaving ultimate decisions on adjustments in relative national interest rates as well as realignments in the hands of national authorities. In the case of realignments, this exercise of authority would, as is already the case in the present EMS, be subject to agreement with partner countries in the ECOFIN Council.

The three instruments provide examples of all three types of pooling referred to above. The arbitration function on national interest rates would imply some pooling of authority, though the collective recommendations would not initially be binding in stage II. The pooling of international reserves would imply the partial pooling of an important instrument and, by definition, some pooling of operations. Finally, the assignment of a new instrument - variable reserve requirements - is an exercise in the pooling of both instruments and a significant degree of monetary decision-making authority.

It remains to consider how the one decision in the EMS which is today subject to *de facto* joint decision-making, viz. *realignments of central rates*, could be handled in stage II. Would there be a case for vesting authority over this instrument with the ESCB as part of monetary management rather than leaving it as in the present EMS with the ECOFIN Council? There are arguments for and against such a transfer.

A major purpose of setting up elements of a collective monetary authority - the ESCB - *before* the irrevocable locking of parities which marks the transition to the third and final stage of EMU is to constrain realignments and eliminate the need for them. A more specific objective would be to ensure that the occasional and rare recourse to them will be made in sufficiently small steps to preserve continuity of market exchange rates around realignments. This has been an important feature in the containment of speculative pressures in the recent EMS experience. If financial market participants interpret a transfer of authority for making the residual small realignments to the participating central banks as part of the ESCB's task as a signal of an intended tightening of the EMS in the transition to full EMU, such a transfer could prove stabilising and hence desirable.

Putting the question in this way, however, suggests the counter-argument, viz. that governments might not succeed in conveying such a signal. They might instead feel relief at not having, as in the present EMS, to bear the political burden of visibly initiating a realignment - and without a new, more hidden, discipline inherent in membership of a union with irrevocably fixed exchange rates. The Council of the ESCB might be faced with *fait accompli* situations in which only a realignment would ease tensions and with national policy-makers blaming either private speculators or the central bankers themselves for the outcome. This would imply a deterioration relative to the recent performance of the EMS.

On balance, these arguments suggest that the decisive considerations in assigning the authority to undertake realignments are how close participants have come to meeting the prerequisites for full union. It would be dangerous, if feasible, to shift the responsibility for deciding on realignments to the ESCB in stage II, if any major divergence of economic performance has persisted into that stage. But it would be desirable to shift that responsibility, if the need for realignments were generally accepted as residual only, and if adequate monetary instruments for underpinning fixed rates had been assigned to the ESCB along the lines proposed above. A tentative conclusion is that the authority to decide on realignments could become part of the mandate of the ESCB in stage II, but that this is less of a priority than the attribution of the other, day-to-day, instruments of an increasingly collective monetary policy.

iii) Stage III: 'hard' union, collective authority over economic policy

The present subsection can be brief, since we have already in our evaluation of costs and benefits of EMU in Part One looked at the main features of the final stage. Relative to the intermediate stage the main changes are the irrevocable fixing of exchange rates, in our view soon to be followed by the introduction of a common currency, full centralisation of monetary authority in a European System of Central Banks, and the transition to binding rules and procedures in the macroeconomic and budgetary field.

One purpose of aiming for the early clarification, through the negotiations in the intergovernmental conference, of the substantive and institutional provisions of the final stage of EMU, is to give a maximum of constructive feed-back to the learning process in the intermediate stage - and even to the first stage, as indicated in subsection (i) above. The approach in designing the final stage should accordingly be pragmatic and prescriptive at the same time; pragmatic in the sense that recent experiences in operating the EMS will be evaluated carefully for its strengths and weaknesses, but prescriptive in defining clearly the elements in the EMU towards which the learning process is to be heading. Without a clear signpost for evolution it will hardly be possible to persuade several member states to begin the transition.

In an earlier CEPS publication we discussed the directions of evolution towards EMU. [47] Though some of that discussion has since been superseded by the Delors Report and by much more detailed studies of how an autonomous and stability-oriented ESCB might be constituted, see notably Louis (1989), we still wish to draw attention to the basic features of an ESCB outlined in our earlier paper.

The challenge to those charged with the design of the new institution - the 'competent bodies', i.e. the Committee of Governors, the EC Monetary Committee, and the Councils of Finance Ministers and of Foreign Ministers - is to set up an ESCB which combines operational efficiency with adequate representation of regional/national views, autonomy vis-à-vis national and EC political authorities in relation to policy design and execution with a degree of accountability to those same authorities for their overall fulfillment of the ESCB's mandate. This poses difficult, but not insoluble problems; one reason for not regarding the difficulties as insuperable is that similar problems have been resolved in other non-monetary areas of EC decision-making as well as in the exercise of monetary authority in large federal states such as the United States and the Federal Republic of Germany.

[47] Gros and Thygesen (1988), Part III, notably pp. 59 ff.

The Delors Report has endorsed a model of the ESCB which is explicitly federal, and the Report offers a fairly precise outline in telegraphic style of its mandate and functions, policy instruments, structure and organisation and its relationship with the political authorities (para. 32). It is vague, for obvious reasons, on the composition of the governing bodies (Council and Board) and the modalities of voting procedures.

The discussion in the previous subsection of Part Two suggested that it is a greater priority to centralise decision-making on a limited member of monetary policy instruments than to centralise operations, though the latter would also confer net advantages. It matters less who executes operations than to make it clear to markets that those operations are part of an agreed common strategy. In this light the decision-making process is crucial.

There are different models in the EC and elsewhere for voting in a way that reflects differences in the size of participating countries. The Rome Treaty uses one such model for voting in the Council, which accords some over-representation for the smaller member states. The composition of the EC Commission reflects another model; the five largest member states have each one extra member. The setting of quotas in the International Monetary Fund offers a third possibility for careful weighing of constituencies of one or more countries in an organisation with a membership too numerous to give all participants a seat and a vote permanently. In our earlier paper we suggested that the weighing of the 12 US Federal Reserve Districts through rotating voting rights might also constitute a model worthy of examination for the ESCB. It is premature to say that one of those formats is clearly superior to the others, but EC member states have ample experience in international and EC cooperation to make a choice and to evaluate how rules for qualified majorities work in other contexts.

A more unique problem for the future ESCB is the balance of influence between members of the ESCB Council nominated nationally (the national central bank governors) and at the European level (the members of the Board). Since other forms of international cooperation are typically less binding and federal in nature, one has to turn to the experience of governing bodies of institutions in large federal states, such as the Federal Open Market Committee and the Bundesbankrat, the two main policy-making bodies in the US and German central banking systems.

The two central issues in this respect are on the one hand whether the majority should lie with the nationally-nominated members or with the Board members to be appointed by the European Council in the Delors Report proposals. Though the ESCB Council would emerge as the inheritor of the functions of the Central Bank Governors' Committee, it could be dangerous and lead to unduly slow decisions if the new institution were to be governed by an only slightly enlarged Committee. We would be inclined towards the US model, where the members of the Board have the majority on the FOMC, in addition to being in charge of some monetary instruments on their own (changes in the discount rate and in reserve requirements), rather than the German model where the Landeszentralbankpräsidenten have, by a historical accident rather than by the legislative design in the Bundesbank Act, a majority in the Bundesbank Council.

On the other hand, there is also the question of how a proper balance is struck between the need for representative procedures in the nomination of both nationally- and European-appointed members and the requirement that the ESCB function as a truly collegiate body; the latter consideration suggests that the ESCB Council as a whole be vetted on proposed nominations.

In a number of respects it is easier to design the monetary aspects of the final stage of EMU than those of the intermediate stage. Above all, most of the preoccupations with the relative performance of nations and their currencies which are at the centre of the EMS will fade gradually into the background as monetary policy becomes increasingly focused on aggregate behaviour internally and in relation to third countries. Monetary control procedures will begin to look more like those familiar from individual countries. It would be useful to give explicit recognition in the design of monetary instruments for the intermediate stage that they give a pointer also for evolution towards the EMU and the management of the common currency which is to emerge as an early integral part of EMU. The most important example is in our view that the system of reserve requirements applied by the ESCB to domestic money creation by the national central banks (or to DCE) in the intermediate stage can be seen as a precursor to the emergence in EMU of a Community-wide money market extending beyond the central banks to individual commercial banks and financial markets. Such an evolution is described more fully in Gros (1989c).

Summary and conclusions

In the introduction we referred to four main issues that arise in discussions about monetary union. In this concluding section we will try to summarise briefly our discussion of each issue.

i) *What is the meaning of 'monetary union'?*

We suggest that due to various transaction and information costs the conventional definition of a system of irrevocably-fixed exchange rates (plus full capital mobility) does not lead to complete monetary integration. The introduction of a common currency would be required to achieve this.

ii) *Would the creation of a monetary union be beneficial on purely economic grounds?*

Our analysis suggests that 'irrevocably' fixing exchange rates involves costs as well as benefits. The main cost is the loss of the exchange rate as an adjustment instrument, the main benefit is an increase in the credibility of monetary policy and the elimination of purely financial shocks as a source of exchange rate tensions. It is difficult to establish a precise balance of costs and benefits, but it is clear that the costs should diminish and the benefits increase with the increasing integration of the economies of the Community. A system of irrevocably-fixed exchange rates might have to be supported by some central control over excessive budget deficits if they threaten the credibility of the exchange rate commitment, but tight control over short-run demand policy might not be practicable.

The introduction of a common currency would yield substantial additional benefits, but no costs, provided exchange rates do remain fixed, and would therefore increase the net benefit one could expect from a monetary union.

iii) *What concrete steps would be needed to establish a monetary union?*

We argue that institutional steps beyond stage I would be needed to create a monetary union. Currency competition, although appealing from a theoretical point of view, is unlikely to lead to substantial progress in a stage I environment, where inflation rates can anyway be expected to converge at a lower level. There is no need to push currency competition as a mechanism for anti-inflationary discipline, as long as the proposed joint monetary policy is based on a clear mandate to aim for price stability. Progress beyond stage I might also be needed because the leadership role of the Bundesbank would be weakened as other currencies become stronger because realignments are increasingly perceived as unlikely.

What institutional steps should therefore be taken beyond stage I? Following the Delors report we recommend that the European System of Central Banks (ESCB) should be created by a revision of the Treaty. The ESCB should be an emergent European central bank. It should lead gradually to this ultimate degree of joint decision-making by a combination of pooling of operations, instruments and authority. The instruments (and therefore also the authority to use them) to be pooled might be adjustments of short-term interest rate differentials, intervention policy vis-à-vis third currencies and reserve requirements. We briefly discuss the various ways in which the ESCB could use the last instrument to mimic the structure of national central banks at a European level because this instrument might be the decisive one in allowing the ESCB to increasingly determine overall liquidity conditions. An important additional consideration in designing the instruments for the ESCB is that they should allow for a smooth passage to the final stage of EMU with a common currency and a European central bank.

iv) *What institution would be needed to govern a monetary union?*

Our discussion of the institutional design of the European central bank has been brief. We still subscribe to the views expressed in earlier publications that such an institution should be federal in structure, have as its prime target price stability, and be independent of national and Community political influences, but also accountable for its operations. We did not feel that we had the necessary expertise to discuss the institutional details. A further discussion of these general principles, moreover, did not seem essential since they are by now widely accepted.

Postscript on the calendar and the agenda of the EC *

When the present paper was written in the autumn of 1989 our discussion of the issues appeared to us sufficiently comprehensive. With a minor update to take into account the conclusions of the December 1989 European Council in Strasbourg we expected to publish our paper in the proceedings of the CEPS Annual Conference early in 1990 with no further major amendments.

Since the fall of the Berlin Wall in November 1989 and the rapid widening of the EC agenda to design constructive responses to the unexpected political and economic reforms in Eastern Europe, we have felt uneasy about leaving the paper in the present shape. We had a further warning in the speech by President Jacques Delors at the CEPS conference, reprinted as an introductory chapter to this conference volume, in which the main proponent of monetary unification as a first priority argues that the neofunctionalist approach may have to be superseded by facing up to the institutional requirements of political integration. More recently the proposal by the government of the Federal Republic of Germany to make a monetary union with the German Democratic Republic has raised further doubts in the minds of may observers and among financial market participants whether EMU as envisaged in the Delors Report and in the present paper remains feasible. We believe it is, but we would not want to leave the reader with the impression that we are unaware of the complications which have arisen and of the fact that the issue of widening participation in the EC versus the deepening of the cooperation among most of the present EC member states towards EMU has arisen with new force. We have chosen therefore to add this short and necessarily very superficial postscript.

In doing so we found it useful to draw up a schematic timetable as an indicative scenario. It is definitely not meant to be a prediction of what will happen, but it may serve the purpose of clarifying what in our perspectives - no doubt by many regarded as optimistic - is the minimum delay required before EMU can be achieved, taking into account the interrelations between the parallel processes of deepening and widening of the EC. It is optimistic in the sense that is assumes that agreement on EMU will be reached and ratified by all member countries and that no major economic and political upheaval arising from the reforms in Eastern Europe will destabilise the entire process.

The purpose of this brief extension of the paper is to bring out explicitly underlying assumptions regarding (1) the feasibility and the speed of the move-

(*) The following is based on 'Towards EMU: fast track scenario', Daniel Gros and J. Pisani-Ferry, Brussels, mimeo, February 1990.

ment towards EMU and (2) the interactions between four distinct issues that will arise for the EC in the 1990s:

i) Institutional/legal issues in the negotiation of Treaty revisions in the Intergovernmental Conference and the subsequent ratification process: design of the ESCB, possibly of the authority to impose binding fiscal rules, and the institutional reform related to enlargement.

ii) Convergence in monetary policies according to the gradualist vision of the Delors Report, focusing on the catching-up process of countries not participating in the exchange-rate mechanism and on the management of that mechanism by the full participants.

iii) Adjustment policies in countries with the presently highest inflation rates (on external imbalances) and public debt (Greece, Portugal, United Kingdom, Italy and Spain).

iv) Possible paths for enlargement, regarding both the EC as a whole and the process towards EMU, for present members of EFTA and for Eastern European countries.

Though these four issues may interact more continuously, we are interested primarily in the implications for the progress towards EMU. Here the framework of the Delors Report with fairly well-defined stages may be useful, since minimum progress required to pass to a subsequent stage puts all four issues into focus.

From stage I to stage II

The minimum delay is determined by institutional factors. An Intergovernmental Conference, even when confined to the relatively precise agenda under (i) above, could take the calendar year of 1991 to complete. Ratification by national parliaments, possibly in some cases supplemented by a referendum, could take another year. This time horizon would also allow the United Kingdom to debate EMU in the national election which is to be held no later than the spring of 1992. Passage to Stage II could take place on January 1, 1993 to coincide with the EC deadline for implementing the single Market.

As regards the functioning of the EMS in the first stage the two main assumptions are that both the United Kingdom and Spain would find it possible to participate with the normal fluctuation margins of $\pm$ 2.25 per cent in the course of 1991 and that Spain and Ireland would, at the latest by the end of 1992, be ready to remove capital controls as fully as the other eight member states will have done

by 1990. These are not radical assumptions.

No substantial economic policy adjustments may be required during the first stage by those EMS members who have long observed the normal fluctuation margins; we refer to Part One, section 5 for some comments on transitional problems. It is assumed that Italy will make a sustained effort to reduce its budget deficit, that the UK will succeed in reducing inflation and that Spain will contain its growing external imbalance. The new Convergence directive would be used to monitor progress made by these countries. With nearly three years to go until the second stage begins, the task of making policies in these three countries compatible with the requirements of tighter institutionalised cooperation is not unmanageable. Portugal and Greece are in a different category, as it would not be realistic to expect them to be ready to participate fully in Stage II from 1993; the EMU Treaty would have to contain provisions for a transition period. As indicated in the Delors Report (para. 44), flexibility concerning the date and conditions on which some member countries would join certain arrangements should not prevent other member states from moving forward, as long as a consensus on the final objectives for the EC exists and has been confirmed by the Treaty revision.

An issue to be settled is whether the end of stage I (or the beginning of stage II) should be used for a final realignment between the EMS currencies, aimed at establishing real exchange rates consistent with the perceived fundamentals. The institutional commitment to going well beyond the EMS towards a full EMU would provide a guarantee, or at least a major occurrence, of stable nominal exchange rates for the future, hence the issue of undermining carefully built-up credibility would not arise in as acute a form as in the present system. But there could hardly be scope for any major realignment, given the unavoidable tendency for national inflation rates broadly measured to be driven apart by such a move.

The immediate issue regarding enlargement is the prospect of a monetary union between the Federal Republic of Germany and the German Democratic Republic. We assume that such unification will take place in the course of 1990 and that it will be followed before the end of 1992 by a German confederation which would then effectively be the German member of the EC and of whatever monetary arrangements exists at the time. Would that require a wait-and-see attitude to EMU until the impact of this major real disturbance, which clearly affects Germany more than the rest of the EC, has settled down? (We refer to our shocks as an argument for preserving the exchange rate as an instrument of macroeconomic adjustment).

Many would argue that the shock to the German economy, notably in the form of major investment needs and added strain on public finances in the FRG, would be destabilising in a European context since it would drive German interest rates up and create tensions in the EMS. We recognise the risk of transitory disturbances, but they should be seen in the context of the relatively modest size of the GDR economy and the very solid foundations of the economic performance in the FRG. We rather tend to regard monetary integration of the GDR into a German market economy as a potential stabilising feature in the context of the time scale for moving towards EMU which we have in mind. Monetary and real integration with a German confederation will provide a major challenge to German economic policy which the latter is bound to take up. The combination of the upward shift in the labour force of the FRG which has already occurred through migration, and the major challenge for public and private investment as well as for the provision of public services and transfers during a prolonged catching-up process in the GDR, will lower the current account surplus from the present excessively high level and will remove for a number of years the fear that a demographically and structurally constrained German economy would impose slow growth on her partners in the progress towards EMU. German inflation may temporarily be higher than it would otherwise have been; that would not be desirable for either Germany or her partners, but nor would it be deeply upsetting to the efforts to move towards EMU, as long as the basic aim of medium-term price stability is retained. In this perspective we see no major reason why German monetary unification and subsequent steps should delay moving beyond stage I. Rather, the EMU negotiations could be started with more confidence once the current and understandable preoccupation of designing the main features of the German monetary union have been addressed.

The other, much less dramatic but still important, issue on the enlargement agenda is when the EC will be prepared to discuss association arrangements and membership with potential new members. Austria has already applied for membership. Austria and Norway have made soundings to explore what meaning could be given today to the status of having their currency associated to the EMS. The very prospect of an acceleration of the move towards EMU has prompted reflections in other EFTA-countries as well that the 'acquis communautaire' may develop so fast that they have to reconsider their reluctance to aim for full membership now rather than later. Several countries in Eastern Europe - Hungary, Czechoslovakia and possibly others - are beginning to express a long-term interest in membership and, in the shorter term, in association arrangement with the EC.

It is not obvious why these expressions of external interest should justify any delay in the EMU process. Countries that have applied for membership and meet the basic conditions of full EMS participation - freedom of capital restrictions,

readiness to accept the normal EMS margins and the principle of collective influence over their exchange rate policy - have a justified expectation that they could associate their currency to the EMS in the first stage. To go beyond that the accession negotiations may have to be completed first. Only Austria is close to fulfilling the initial conditions, but Norway and other EFTA-countries might in principle do so at shorter notice than several present EC member states. If there are additional applications and if the Intergovernmental Conference were to get well under way, the EC would be under some obligation to give these countries a change to participate as associate members in the EMS and to become full members in the EC and the subsequent stages towards EMU.

The time perspective for potential East European members is obviously much longer, because the adjustments to be made are more fundamental. Their potential participation could arise only will beyond the completion of stage I as here envisaged. In any case a lengthy period of association would be required.

From stage II to stage III

To many observers both the purpose and the desirable length of stage II, as proposed in the Delors Report and elaborated here, are controversial. As we have argued in Part Two the main rationale for stage II is to provide early learning experience with genuine *ex ante* coordination of monetary policies, but without definitively abandoning national responsibility for the exchange rate. A further purpose is to build an anti-inflationary reputation for the new ESCB which begins to function after the ratification of the revised Treaty at the end of stage I.

Stage II is complex, because authority is divided between the national and the EC level; full EMU with centralisation of monetary policy is simpler and more robust. If an important group of countries think they can more safely and move directly from a successful stage I to full EMU than via an intermediate stage we would have few objections. We have developed our analysis of stage II in response to what we perceived to be a method of transition preferred by traditionally gradualist policy-makers and central bankers. We have always believed that this stage could be relatively short. In the present illustrative scenario we have limited its length to three years, i.e. the transition to the irrevocably fixed rates in the final stage of EMU could take place at the beginning of 1996.

In addition to the learning-by-doing and reputation-building purposes of stage II we see in the complex interaction with the enlargement and institutional issues an additional purpose in preserving an intermediate stage. Such a procedure would make it easier to separate more clearly the longer-run institutional issues and integration with Eastern Europe from the agenda required to establish the principles of EMU and the characteristics of an ESCB to run a joint monetary policy. It remains our view that both the question of democratic control with the ESCB and the remodelling of existing bodies to assure fiscal coordination are more limited than the proper balance between EC institutions in the long run and with a potentially much enlarged membership. The three years here seen as the duration of stage II could serve also for embarking on this wider set of issues in a second round of negotiations. Raising them all at once in the forthcoming Intergovernmental Conference could risk delaying the relatively few decisions necessary to clarify EMU and the move beyond stage I. Postponing the latter decisions until the broader issues have matured would similarly prolong a stage I which we consider to be inadequate to the tasks of the 1990s and to increase the number of participants in the negotiations to such an extent that the latter could drag on for very long.

A time horizon to early 1996, i.e. nearly six years from now, seems adequate to assume that the move to full EMU could encompass the present EC membership. An adjustment that cannot be done in six years may not be realistic within any time frame. If a calendar of the type we envisage is clarified early we believe that also Greece and Portugal could be ready for full participation by 1996.

Finally, because of the political significance of a common currency, we assume that this step has to be taken by the entire Community at the same time. However, once agreement on the final goal has been achieved, the economic equivalent of a common currency could be approached, if desired from the start of stage III, by a group of countries adopting zero margins and par clearing obligations for both central banks and private banks of the participating currencies. For the reasons we have developed in Part One we believe that there would be advantages to countries in accelerating the adoption of a common currency in order to keep the full benefits of monetary integration. But we believe that a realistic time scale for the transition to a common currency could be at most 3-4 years after the start of stage III.

Tentative scenario for EC Agenda

	Institutional/ legal	Monetary policy, EMS/EMU	Individual Country adjustment	Enlargement/ associated members
1990	Stage I starts	Italy goes to ± 2.25% margin; full capital mobility within EC8 + UK		FRG forms monetary union with GDR; EC discussions with EFTA
1991	Intergovernmental Conference agrees on EMU Treaty	UK joins EMS with ± 2.25% margin; Spain goes to ± 2.25% margin	Budgetary and external imbalances in Spain, Italy, Greece and Portugal reduced	Association agreements with Eastern Europe. Austria and Norway become associate members of EMS and apply for membership
1992	EMU Treaty ratified by EC12 (+ Austria and Norway?)	Full capital mobility within EC10 + Austria and Norway		German confederation becomes part of EC/EMU
1993	Stage II starts, ESCB created (by EC14?), special status for Greece and Portugal?	Final realignment? reduction of margins to ± 1% except for Greece and Portugal		East European countries (Czechoslovakia, Hungary, + ?) and EFTA-countries apply for EC membership
1994	Intergovernmental Conferences agrees on reform of EC institutions	Additional currencies from EFTA join stage II with margins of ± 1%	Budgetary and external imbalances in Greece and Portugal to be fully adjusted	Enlargement negotiations completed
1995	Revised Treaty on EC institutions and enlargement ratified. Decision to go to stage III			
1996	Stage III starts. Special status for Greece and Portugal ends. Special status for new members from Eastern Europe begins?	Irrevocably-fixed rates for EC14. Preparations for common currency begin	Adjustment programmes in new East European member states	
1998-2000	Transition to common currency for EC20 + (?)			

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4 Unfinished business: the credibility of 1992

Jacques Pelkmans and Peter Sutherland

Introduction

The single market is in the making. Good progress has been made in terms of the count of the number of adoptions by and common positions of the European Council. Also, in qualitative terms, the issues of more than half of the major dossiers - once expected to be exceedingly hard - have been resolved. In significant areas there is reason for concern, however. Looking at the building site as a whole, the assessment can only be moderately positive. However, since the goals of '1992' are very ambitious and the decision-making capability of the EC-12 remains relatively poor, such an assessment amounts to a reasonable score. The spirit and performance of the European Community of today are immensely more positive and attractive than only five years ago. '1992' has had a formidable impact already and greatly raised expectations for Europe's future. Yet this is a double edged sword because, whilst expectations provide a stimulus for the completion of the Internal Market, if they are not fulfilled they will lead to a sense of disillusion and will cause fatal damage.

In our paper we shall take a closer look at the single market's building site. However, this is not a progress report of the White Paper. Although the speed of decision-making and the total number of adoptions do matter, it is the overall strategy of pursuing the single market which is decisive. A winning strategy must effectively deal with central issues and approach substance by concentrating on a few highly significant dossiers. The ultimate test for the success of the strategy is whether reasonable expectations, based on firm commitments in the White Paper, the Single Act and subsequent European Council resolutions are met. Citizens, consumers, traders and businesses must not lose confidence in the project through continued fragmentation, problematic market access, persisting frontiers and substantial differences in competitive conditions caused by member states' interference.

Therefore, the central question we shall ask is concerned with the *credibility* of the single market programme as it stands today. Despite the initial victory over scepticism about '1992', its credibility is still tenuous. We hold it essential that '1992' is approached on the basis of an overall strategy having as its highest aim not merely to 'complete' the internal market in some political or formalistic sense but to make it credible to citizens and market participants. Some such strategy is imperative since Europe cannot waste its political, bureaucratic, judicial and business energies for almost eight years for a single market which would only exist in name, leaving numerous instances of fragmentation in place in forms somewhat different from those used in the past. '1992' is not just expected to deliver some trade facilitation and the symbolic accomplishment of specific economic freedoms, but, rather, a truly single market without internal frontiers, enabling a freedom of manoeuvre for everyone and a level of challenge rendering competition in all products and services markets truly Community-wide.

1. The credibility of '1992': a universal concern

The White Paper and the qualified majority voting agreed to in the Single Act are frequently said to have raised the credibility of the single market objective. It is perhaps more correct to say that these developments helped to *restore* credibility. It still took another one to two years before credibility had been sufficiently enhanced to overcome the threshold for active market response. Disbelief and scepticism lingered on until the actual test of the Council's decision-making capacity was apparently met. The 'Europhoria' only began after the rapid Council decision on the major dossier of 'economic and social cohesion' in February 1988. Current market behaviour is built on a vague sense of anticipation and fuelled as much by imitation of rivals, cross-hauling in one another's markets and calculated needs for strategic business alliances, as it is by a firm belief in '1992'. Many of the business surveys on '1992' still concentrate on the results of questionnaires asking what the convictions and plans of top managers are. What better mechanism for mutual persuasion about the advent of '1992' can one wish? Permanent monitoring by the newspapers and great sensitivity about the remaining hard dossiers indicate how thin the ice is on which the EC is skating and how fast it needs to go to reach the goal of '1992'.

Indulging in the dream of 'irreversibility' and the '1992 momentum' can blind us to the critical issue of credibility. Credibility is demanding and requires investment by many; it has a long gestation period building on many small successes, yet can be destroyed by only a few failures. The *European Council* must show credibility through decisions whose speed, number and nature continuously confirm its determination to put the single market in place. The *European Commission* should be credible not only in tabling its proposals on time but also in finding appropriate solutions to the questions of what ought to be regulated, how and at

what level of government - EC, national or federal or some combination of these.

This is a challenging task given the original principles contained in the White Paper. The application of principles such as those regulating only the 'essential requirements' in technical EC directives, while employing 'references to standards'; 'home country control' in financial services, based on a sufficient yet 'minimal harmonisation' of requirements for financial institutions, combined with 'mutual recognition'; mutual recognition in fields where Art. 36, EEC or other legitimate exceptions play no role. This process involves steering a difficult course between what some perceive as overregulation from Brussels and others as a 'regulatory gap' for consumers or smaller enterprises.

The *member states* must contribute to credibility in a number of ways. Political will in Council negotiations being crucial in any event, member states' duties really only begin *after* the Council has adopted legislation. Community law will remain a paper tiger if it is not adequately implemented and enforced at member-state level. Indeed, most of the activity associated with '1992' is not to be found in Brussels despite all the political and journalistic attention spent on it; rather, the work is to be done at home. In ratifying the Single Act, member states have bound themselves to bring the single market into being. The subsidiarity principle, explicitly mentioned in the Act, requires that regulation and policy-making should be at Community level only insofar as it is inappropriate or impossible to deal with the matter at national level. Even if it is appropriate to deal with it at the EC Council level and legislation is adopted, the bulk of it is in fact implemented at national level. For the remainder as well as some borderline cases, the application of the subsidiarity principle should result in implementation at EC level, but member states may still contribute to credibility by endorsing effective forms of delegation of such powers to the Commission. As we shall see later on, the credibility of '1992' hinges in no small part on other activities of member states such as adequate cooperation on the EC-national interface, and well-developed inter-member state cooperation on a host of issues. Of course, member states are not uniform monoliths; they have different institutions which may all contribute in various ways to the making of the single market.

The prerequisites for a well-functioning single market, to the benefit of Europe and others, need to be such that *consumers* are faced with more choice and find regulation credible enough for their quality of life, that *traders* themselves see frontiers eliminated and observe their costs being reduced, and that *producers* can penetrate private and public markets in other member states without discrimination.

The principles set out in the White Paper may substantially gain in credibility with the active cooperation of these categories of participants in the build-up phase of the single market. Apart from their active engagement in the phases *preceding* the political decision-making process in Council - the usual focal point - all three categories are critical for providing inputs into the monitoring activities of the Commission and can help enforcement by complaints and the search for legal redress.

In various configurations they are essential to write European and international standards for products and services. Activism by suppliers is necessary to break down the 'fortress' mentality in national public procurement. Traders and other intermediaries such as travel agents and insurance brokers will also have to subject the single market to the credibility test.

2. Completing the single market: a strategy

2.1 Sticking to priorities

'1992' has become an extraordinarily complicated effort in an era of rapid and amazing change, especially in Europe and between the superpowers. Without steadfastly pursuing a well-thought-out strategy, the Community may lose sight of its priorities and lack the determination to accomplish the single market.

With the White Paper as the agenda and the Single Act as the solemn underwriting of the aim of '1992', the main hurdles for embarking on a strategy might seem to have been taken. The goal is clear, how to get there and when we pass what stage is all specified in some detail. No doubt this view is correct. The strategy set out in 1985 has proved to be effective. Some impressive results have already been achieved. The fact that 1987-1989 real annual economic growth rates were more than 1% above medium-term economic growth forecasts made in 1985 and 1986 is almost certainly attributable to '1992', in particular to the investment boom and rapid intra-EC trade increase it has induced. World trade is also growing fast, but the EC itself is a major contributor to the higher temperatures on world markets, both on the export and import side (and despite a relatively low dollar). Unemployment is falling, and rapidly so in some EC countries.

However, we are only just beyond mid-course. Some hard decisions still have to be taken and the sectoral services dossiers need more attention. We shall also show at some length that '1992' requires dramatically more dedication to the implementation and enforcement issues, that is, problems arising *after* the Council of Ministers has adopted legislation. Moreover, higher ambitions have been linked to '1992', such as the social dimension and economic and monetary union. The external dimension of '1992' - absent from both the White Paper and the Single Act - demands attention as well, in particular the special relationship with EFTA, our largest trading partner. Towering above everything else are the peaceful revolutions in Eastern Europe and the unification of Germany. Governments and the peoples of Eastern Europe look to the EC for all kinds of support. They openly speak about association and even future membership.

Precisely because of these higher ambitions and exciting developments, the European Community must complete its internal market. A setback in the single market programme would seriously damage the credibility of '1992' to business. It would undermine the conviction that the EC, with its powerful single market, is capable of fulfilling the higher ambitions. It would deal a blow to the belief of East Europeans that the EC has the economic coherence, the force and the responsibility to assume a measured form of leadership in pursuing prosperity on this continent. We must therefore stick to the strategy and its priorities. We should also keep in mind the 'guiding principles' of the 1992 process. It is appropriate to remind the players of these principles since adherence to them will greatly facilitate progress and sustain credibility. They will be discussed briefly in section 2.2.

As to the substance of the '1992' programme, four critical conditions have to be met if credibility is not to be impaired, with all the regrettable consequences this would have for the economic objectives behind the programme. These conditions are set out in section 2.3. and elaborated in the remainder of the paper.

2.2 The guiding principles

'1992' has not suddenly arisen. The completion of the internal market is in fact the result of a succession of seemingly separate events, dating as far back as the late 1970's. These are the White Paper itself; the Single Act (preceded by the intergovernmental conference in Luxembourg, the Dooge and Adonnino reports and the Spinelli draft Treaty of European Union proposed by the Parliament); various Delors Plans; interaction with economic case-law from the Court of Justice of the EC (CJEC) and subsequent policy statements by the European Council. It is probably helpful to group together the eight 'guiding principles' of 1992. They form a remarkable set, introducing flexibility in institutional as well as substantive matters while aiming for the ambitious single market aim. Jointly they guarantee a much more cooperative attitude by member states' governments and, presumably, a higher quality of substantive legislation. They also enable much greater economic freedom of manoeuvre for business and more choice for consumers without necessarily endangering the 'essential requirements' of health, safety, consumer protection and the environment.

There are three institutional principles. First, *more qualified majority voting*.

The word 'more' has a double significance here: not only has the Single Act introduced qualified majority voting for more Articles than in the original Treaty of Rome; the actual use and acceptance of majority voting in the Council has now become a fact of life. This has greatly facilitated the decision-making process and, to some degree, returned to the Commission (and the Presidency!) tactical possibilities for obtaining agreement. The greater institutional influence of the European Parliament would also have remained without effect, one presumes, if unanimity had not been pushed back so much.

Second, *an emphasis on rule-making*, not on budget outlays. The only major exception to this principle is the doubling of the structural funds. The economic and political reasons for this exception remain as valid as ever. The principle is remarkable in itself, since rarely are great objectives achieved without recourse to spending. It is obvious that this principle significantly reduces a potential roadblock to '1992' because in many member states there are political or budgetary restraints on greater EC spending.

Third, *no major new powers to the Commission* for the time being. Again, this clearly reduces member states' resistance to the restraints on their autonomy which they have already accepted. To what extent the principle of subsidiarity (see below) and this principle can be combined, without at least some more delegation of power for executive and management issues to the Commission, remains an important question. Some member states cherish such narrow and unimaginative perspectives on delegation that they define almost anything as a 'major' increase in power for the Commission. As will be emphasised later in this paper, in refusing to delegate, member states assume a heavy responsibility for executive matters and there is little guarantee of efficient mechanisms. But apart from this point, and apart from the obviously increased role of the Commission as the 'initiator' of proposals, no new powers are considered necessary in the short run.

Another five principles govern the substance of '1992'. Fourth, *no internal frontiers*. The Single Act is crystal-clear about this. The term refers both to physical and regulatory frontiers, fiscal aspects being related to both. At present one observes an inclination to get around the principle without formally calling it into question. Examples include the feared shift of indirect tax frontiers to firms (increasing administrative burdens), and the problems in road haulage. There is no, and there should not be any, escape from this principle.

Fifth, the Single Act has confirmed the *principle of subsidiarity*. Subsidiarity can be traced back to the oldest notions of federalism in the US, itself inspired by the very decentralised set-up of the Dutch confederation of the Seven Provinces in the 17th and 18th century. Its more rigorous applications stem from the economic theory of federalism. This does not mean, however, that applying the principle is mechanical and straightforward. What kind of substantive issues can be resolved more effectively at EC level is far from easy to establish in every instance. It also depends on the decision-making and managerial capabilities at the EC level and the efficiency and effectiveness of its alternative, namely coordination between member states. Mixed solutions are perhaps possible when there is adequate cooperation between the EC and the member states at government level. Finally, subsidiarity may be interpreted differently if the 'democratic deficit' at EC level is reduced and/or if the EC budget becomes more of a policy instrument (though the latter is unlikely before 1993, at the earliest).

Sixth, *mutual recognition*, usually in combination with the seventh principle, *joint regulation in terms of 'essential requirements'*, avoiding detail or delegating some of it to special bodies. The origins of these two principles are in the case-law of the CJEC, especially that based on the Cassis de Dijon ruling of 1979. Its first systematic application is the 'new approach' to technical harmonisation, adopted as a policy before the White Paper was published. In the White Paper and in the '1992' programme ever since, the principles have been applied in other fields such as financial services. The two principles signify a fundamentally new way of thinking and acting in Community affairs. Without them, '1992' would not be possible.

Eighth, as a necessary complement to the previous two principles, *the joint frameworks for national approvals*, licenses, certification, test requirements, etc. so that they too can be mutually recognised.

The imaginative use of these fundamental principles is a permanent challenge to the Commission, the EP, the member states and the private sector. Alternative solutions usually present themselves; original approaches may frequently be added. Together the principles would seem to reflect a more than satisfactory compromise on how to achieve '1992'.

2.3 The critical conditions

To maintain the credibility of the '1992' programme, four critical conditions should be met.

First, decision-making should not be perceived as dodging the remaining 'hard' dossiers. The fact that quite a few hard dossiers have been resolved is gratifying; however, lingering doubts will be confirmed and credibility undermined if major technical and sectoral dossiers before the Council are not firmly resolved. This is briefly discussed in section 3. Second, the implementation and application of '1992' measures should be transparent, adequate and timely (discussion in section 4). Third, adequate legal redress in the event of improper implementation or application of single market Directives would give confidence in and credibility to the single market programme, especially for citizens and market participants (discussion in section 5). Fourth, the regulatory complexities - despite the liberalising nature of '1992' - require intense vertical cooperation between member states and the EC Commission (and other EC institutions) as well as horizontal cooperation between the member states (discussion in section 6).

3. Evaluation of progress in decision-making

There are two ways of assessing progress on the White Paper programme. Both are important. One is a 'numbers game', an inevitable consequence of regarding the White Paper as an all-or-nothing proposition and not as '1992 à la carte'. The White Paper's calendar is a useful tool to manage the process of tabling proposals on time and disciplining the COREPER working groups and Council.

The Council's presidency in particular can maintain pace and focus so as to serve the overall purpose of 'getting there by the end of 1992'. For these reasons, counting the number of adoptions and common positions is a useful and necessary method of assessment. However, it is only sufficient if combined with the method of assigning different weights to dossiers and checking whether progress is made on those being considered as important and hard to adopt.

3.1 Quantitative assessment

By early February 1990, 143 proposals from the White Paper programme, as revised, had been finally adopted and 9 were partially adopted. Table 1 provides more details. In terms of overall numbers progress is satisfactory: around 60% of the proposals are now adopted or partially adopted. Moreover, among the 127 proposals still to be adopted, there are six common positions of the Council whilst a larger number are in second reading before the European Parliament.

If the grand total is broken down into four categories, as above, the fiscal category is conspicuous for its almost total lack of progress, at least if one merely looks at formal Council decisions taken. In technical harmonisation, by far the largest single category in the White Paper, progress is good although the remaining workload is considerable especially for veterinary directives. Frontier controls show a relatively high number of adoptions; however, this figure conceals some difficulties discussed below. In the group of 'other proposals', including financial and non-financial services, a general assessment based on mere numbers could never do justice to the highly diverse issues in this group. Certainly, the

Table 1
White Paper proposals: numerical progress
(situation 6th February 1990)

Proposals*	adopted	partially adopted	to be adopted
frontier controls			
- goods	5	1	4
- persons	4		4
technical harmonisation			
- veterinary	24	3	
- phytosanitary	10	1	40
- food	15	2	5
- industr. goods	41		16
fiscal proposals**			
- VAT	3		10
- excise	1		11
other proposals			
- public procur.	3		3
- labour/professions	7		7
- financ. services	15		7
- transport	4	2	7
- cap. movements	3		-
- other	8		13
Total	143	9	127

* After reshuffling and some withdrawals, the White Paper programme is no longer fully congruent with the Annexe to the White Paper, as published in June 1985.

** The original number of the fiscal White Paper proposals has limited significance, in the light of two major revisions of the approach taken (in 1987 and in 1989).

Note: 'to be adopted' includes 6 common positions of the Council.

workload is still substantial but hard to express appropriately in a simple numerical count of directives.

3.2 A qualitative evaluation

A qualitative assessment also brings out a fairly positive picture. Such an assessment is by definition more subjective as the weight given to each dossier cannot be verified in an objective manner. It is misleading, however, to solely emphasise the hard dossiers still outstanding, and to ignore those adopted. Therefore, we shall distinguish three categories of major and hard dossiers and discuss each one briefly: hard dossiers already resolved or showing good progress; hard dossiers *showing* a mixed picture; and hard dossiers encountering blockages.

3.2.1 Accomplishments

The first four years of executing the White Paper clearly show that a substantial number of major, tough dossiers are no longer blocked or indeed have been partly or fully resolved. The reader may cherish his/her own subjective list of hard dossiers since mid-1985 but we think that several, if not all, of the following dossiers should be in it:

A. removal of *exchange controls*; free movement of financial capital. A taboo remained on these issues as late as 1985 in at least four, probably six EC countries. Full adoption was accomplished by mid-1988, albeit with a fiscal proviso. This proviso was significantly reduced in December 1989.

B. the budgetary plank of economic and social *cohesion*. After four years of bickering about the British contribution, who would have forecast an adoption of the doubling of intra-financial transfers via the Structural Funds, amounting to a very large multiple of the sum involved in 1980-1984? Moreover, who would have expected it to be partly taken out of the share of farm expenditure in the overall EC budget, in the framework of constraining open-ended agricultural support?

C. breakthroughs in *financial services*. The Second Banking directive has been adopted, its analogue in securities trade has reasonable prospects and large-risk insurance is progressing well, in sharp contrast with the situation before the famous four Court cases in insurance (rulings in December 1986). Some progress in direct life insurance was made in December 1989.

D. encouraging progress in the *public procurement* programme. In the light of unquestioned and deep-rooted protectionism in member states' public procurement as well as an almost total failure to comply with the original supplies and public works directives either in the spirit or the letter, current work in the Council is undoubtedly positive. Substantial revision of the two directives has already been adopted as well as a pathbreaking directive on legal remedies. The draft directives on the hitherto excluded sectors, telecom hardware, goods for public transport and supplies to utilities, have been seriously negotiated.

E. *television without frontiers*. The sensitive TV directive, having caused a fierce debate in many EC countries about the balance to be struck between national culture and the free movement of (hence, unhindered consumer-access to) broadcast services as well as about the extent and form of commercial TV, was adopted early in October 1989.

F. *the merger control directive*. This dossier was so difficult that one can only be dismayed at finding it among the '1992' proposals - in fact, it dates from 1973 and has travelled through 16 years and a few revisions before being finally adopted in December 1989. Regrettably, there is an issue of quality here because in the fierce struggle about national versus EC Commission competences a good deal of the economic purpose of the original proposal has been vitiated. Nevertheless, particularly for larger firms, the adoption resolves an important issue of legal insecurity in the Single Market, and in so doing enhances the credibility of '1992'.

This short list amply demonstrates that it is not correct to say that the hard decisions are postponed whilst the easy ones are given artificial priority. Nevertheless, this is a widespread popular belief, kept alive by the tendency of newspapers to report in a conspicuous and non-technical fashion blockages and skirmishes ocurring before adoption.

3.2.2 Slow movers

Scepticism creeps in when listing hard dossiers where progress has been made but is moderate. Should one emphasize that the glass is half-full or half-empty? Compared to the situation before the White Paper, one could speak of progress in road haulage (with its programme to enlarge the number of quotas rapidly so as to make them disappear altogether by 1993), and in air transport (where the first package of four adoptions in December 1987 meant a breakthrough, even though the immediate impact on competition was slight; more significantly, political agreement on the key elements of the second package was reached in December 1989). However, it is easy to point to hair-raising difficulties in both sectors as well. The delayed application of the territoriality principle in road haulage and the recent German plans to force the issue in a discriminatory way are a matter of grave concern. The external dimension in air transport as well as the final regulation on intra-EC route entry are perhaps even more daunting. Dossiers like controls on animal and plant health, food law and the gradual removal of national import quotas (usually linked to authorisations, as under Art. 115, EEC) can all be described as examples of difficult subjects, with some accomplishments which are nevertheless insufficient. Particularly in the case of national quotas the recently-agreed first tranches to do away with some 90 quotas with general application, and another 30 vis-à-vis Japan only, are typically not regarded as economically significant (because they were not enforced or, in the Japanese case, no longer refer to competitive imports).

In other words, the glass is perceived as less than half full as far as credibility is concerned. In the car sector individual Commissioners have spoken in favour of gradual abolition and a temporary voluntary export restraint (VER) for Japan. In textiles and clothing, tied up with the revision or gradual abolition of the worldwide Multi-Fibre Agreement, there are still no proposals and the Commission remains silent for the moment. Finally, the Strasbourg European Council adopted the Social Charter. This difficult dossier is anything but finished, since in the course of 1990 and 1991 the social action programme will translate (all?) the high social principles of the Charter into legislation or formal resolutions. The significance of the Social Charter is, above all, to provide a minimum social platform, preventing a competitive social deregulation from taking place between the member states.

3.2.3 Hard dossiers with no progress

Credibility is undermined for a third group of hard dossiers - the obstinate ones, apparently resistant to any attempt to overcome the problem. The worst case is undoubtedly the Community patent, over which a silly trench-war is being fought. Few general observers seem to know that, in 1962/63, the Six almost agreed on an EC patent. It is clear today how costly that failure has been. It took another decade before the Munich Convention established joint *procedures* for patent application in (almost all) EC and EFTA member states and another five years before the European Patent Office could begin its successful services in this respect. Since the Munich Convention, the EC countries have gone through three intergovernmental conferences (1975, 1985 and 1989). There is doubt about the quality of the EC patent agreement after so much haggling. The third conference reached agreement about the key to (re-)allocate the tax revenues on the EC patent and about the difficult issue of translation requirements. However, it is almost certain that, in 1991, a fourth conference will be held. The stumbling block is, once again, ratification in a few member states (i.e. Denmark and Ireland probably). The conference will fix the number of ratifying member states needed for the entering into force of the agreement. Unfortunately, this task will require unanimity.

Frontier controls of persons also falls into this category. Resistance here has a more understandable basis as it is rooted in sensitivities about 'domestic security', about immigration, about aspects of criminal (rather than commercial) law and human rights, about anti-drugs policies rather than more technical issues such as restructuring of airports, at best an argument for brief delay. Moreover, it requires effective and at times swift cross-border cooperation between national or sub-national authorities which member states and their civil servants still have to learn. Matters are also not facilitated by the fact that the ministries dealing with this dossier are by nature inward-looking and lack EC experience.

The Schengen group (France, Benelux, Germany) has broken several taboos in this respect, albeit with some delay and considerable difficulties along the route. By late November 1989, it appeared as if the group would comply with its political commitment to get rid of controls on persons (from Schengen countries): the accords were to be made public on December 15, 1989. At the last moment this did not happen, due to the uncertainties and hence unclear implications of the opening up of East Germany for intra-Schengen frontiers. The rapidity with which events will move in Germany in 1990 makes it hazardous to venture more than speculations about whether and when this blockage will be resolved. The risk is serious that Bonn will assign low priority to Schengen. However, it is not excluded that Schengen *has* fulfilled its purpose, namely to serve as a precedent in showing that both politically and administratively frontier controls can be removed. That is why the accords should be signed as quickly as possible.

Another notoriously hard case is the issue of the early information or even co-determination of workers' representatives in companies located in EC countries. Even though a menu of three rather different options is proposed, significantly reducing the conflict potential, the dossier still has some symbolic value in Community politics.

This leaves indirect taxes. For many in the Community, the proposals on VAT and excise do not constitute merely difficult dossiers but the major test-case for the credibility of '1992'. The reasons consist in the unanimity required, combined with expected domestic political and/or budgetary effects of aligning VAT rates and excise for certain countries. For excise there is the additional problem of strong sectoral lobbying. At the political level the concept of fiscal sovereignty is mentioned occasionally, even though no EC tax is proposed and all that is suggested amounts to a constraint of fiscal autonomy of setting rates.

The constraint follows directly from the mere obligation to do away with every border control. At one extreme one may comply with this obligation without any further tax proposal from the Commission other than accepting the origin principle; at the other extreme, one can complement it with joint regulation of bands of rates *before* controls are lifted. It is hard to see any fundamental difference in the constraint on fiscal autonomy, unless one expects countries not to adjust their rates in the first extreme case and accept all costs of cross-border shopping, etc. *Any* form of realising the Internal Market as defined in the Single Act will necessarily constrain national fiscal autonomy somewhat.

It is our view that the fiscal dossiers have moved ahead considerably and that they may well be pushed through Council before 1992. The long and painful road of EC indirect tax harmonisation has been characterised by an increasing acceptance of flexibility on the part of the EC Commission, especially with respect to VAT rates and excise levels. This is tantamount to saying that moderate degrees of tax competition are no longer rejected out of hand but, rather, are assessed in relation to transaction costs of goods arbitrage between different fiscal jurisdictions. It also implies e.g. for excise, that bilateral disparities between non-neighbouring countries can be higher than those between adjacent member states without any or only a marginal effect on revenues.

Over the years positions have probably shifted enough to come to decisions. Stronger individual EC member states have already begun with unilateral VAT rate and excise adjustments in response to expected fiscal competition with neighbouring member states. The stumbling block would seem to be how to ensure for tax authorities that the destination country gets its destination-based taxes. The EC Commission rightly proposed sticking to the origin principle which is the logical component of a single market. However, even the EC Commission felt compelled to propose a clearing-house in response to member states' insistence on acquiring destination revenues from an origin-based tax system in a single market! The current position is essentially that the member states have rejected this technical 'transcoder' between two opposed principles, because member states do not trust each other sufficiently to make the clearing house simple; they do not want an elaborate clearing house because of its bureaucracy, nor do they wish to rely on macroeconomic statistics as a straightforward basis for regular tax settlements. Rather than concluding that this series of rejections amounts to a convincing case for the origin principle, the ministers declared early in October 1989 that they wished to stick to a *temporary* application of the destination principle.

The October 10, 1989 decisions are only firm on the principles. Neither on details, nor on the calendar, nor on the harmonisation of rates was anything concrete adopted. The only exception was the clear decision that individual cross-border shopping for travellers would be completely free (except for mail orders and cars). The principles adopted include:

- destination principle (for how long?)
- no border formalities (hence no customs controls at borders)
- inter-member state administrative cooperation and data exchange, plus the fiscal duty on firms to declare intra-EC trade transactions (as the basis for administrative control and enforcement).

In December 1989 the Council decided on a standstill-agreement on the VAT rates: rate changes are only possible in the direction of the Commission proposals, or they must remain as they are.

The main virtue is the clarity of the second principle: tax borders (for VAT) will disappear. If this was the lingering doubt in the '1992' programme, it is gone now. Should the ministers change their mind, the announcement can be held against them in the coming years. But many questions remain. The most important ones are the following:

i) are intra-EC exports going to be zero-rated? The conclusions of the ECOFIN Council maintain absolute silence about this crucial aspect. One would assume zero-rating but, without a customs declaration, how can one prove that the goods have actually been shipped across the intra-EC border? It would seem that the receiving firm in the other member state, having to pay the destination VAT anyway, will have to formally notify the exporting firm; perhaps the transport firm might be asked to return one (signed) copy of the freight document. In any event, the a posteriori declarations of firms about their intra-EC transactions will have to be checked somehow before VAT restitution can be applied in the country of origin. It is currently suggested that both importers and exporters fill in a simple filing form. There is, however, a fear that the customs controls of the past will simply be shifted to firms, either as an additional administrative requirement inside the firm or between firms. The 'conclusions' of the ECOFIN of 13/14 November reduce this fear to some extent: 'The burden currently imposed on companies and administrations will be lightened through the elimination of formalities preceding the shipping of the goods or those related to border crossing' (Agence Europe, 15 November 1989). Yet the only specification given is the promise of 'as simple a periodic declaration as possible of these operations for statistical and tax purposes', to be proposed by the Commission.

ii) Inter-member state cooperation on detailed executive matters such as taxes is *very demanding*. We submit that the fear about fraud in the single market tends to be exaggerated and would seem to impose more stringent requirements on the future system than on the present one - in today's system administrative controls of *individual* transactions of exporting enterprises are very infrequent and highly selective; everything is based on confidence in 'bona fide' enterprises, underpinned by infrequent general audits, and *cumulative* VAT reporting to the authorities. In any event, suspected cases will require intense and quick collaboration across the borders. It remains to be seen whether a web of bilateral cooperative links between national tax authorities is really less involved than an appropriate clearing system. As the November 'conclusions' of ECOFIN confirm, the cooperation is to be permanent. Without readiness to cooperate and without mutual trust, neither one will work and business will suffer. Even though it is not politically spectacular, ministers will have to make detailed administrative arrangements, develop exchange programmes, improve on-the-job training and European training and create a climate in which styles and cultural differences between administrations are respected without negative effects on '1992'.

iii) The 'temporary' nature of the destination principle will have to be unconditionally fixed in EC legislation, with a deadline of, say, four years. All that has been agreed hitherto is a 'review' at the latest in 1996! This agreement is too weak and undermines the credibility of '1992', precisely because the indirect taxes form a test-case.

Are the ministers of finance dodging their Community responsibility in the field, in a period when these same ministers courageously set themselves an even more ambitious target of monetary union? Would a firm deadline to shift to the origin principle not be far superior to a vague review commitment? All in all, even among the obstinate hard dossiers it would be wrong to suggest gloom and pessimism. The overall picture is such that the credibility of '1992' is not fatally undermined. However, it remains fragile and needs to be supported especially by successes on the few hard cases left.

4. Implementation

The crux of '1992' is in the markets. For the adoptions by the Council to affect

profit expectations, economic transactions, corporate strategies, consumer choice and trading opportunities, they have to be properly implemented and at the right time. The credibility of '1992', and of the single market more generally, would be seriously impaired if implementation were not taken seriously by national and EC institutions. There are indications, however, that implementation is suffering from delays and serious imperfections.

There are four levels of implementation of Community law:

i) compliance with Treaty obligations, aimed at the proper functioning of the single market;

ii) incorporation of directives in national legislation;

iii) application of the measures, once incorporated in national legislation; and

iv) the effective exercise of the right of recourse.

These four levels are not specific to '1992'; they apply to all Community law, whether pre- or post-1985, whether in the White Paper programme or not (see, especially, the six Commission reports to the EP on implementation). Even when singling out the White Paper proposals, it is crucial to keep in mind that the actual impact of Council adoptions does not only depend on the second level but also - and sometimes critically - on the third and fourth levels. In addition, the effective functioning of the single market is greatly helped by the first level as well, even though little or no special '1992' legislation is involved. A combination of far-sighted economic case-law of the EC Court of Justice, more effective notification procedures for member states and regular consultation between member states and the Commission about notified national draft legislation has greatly improved the prospects for the single market and its proper functioning. These inconspicuous and de-politicised methods are too frequently overlooked when discussing '1992'.

The present paper does not aim to give an exhaustive analysis of the implementation problem. We call for sufficient attention to the problem at the levels of the member states, the EC institutions and the private sector. We also insist on avoiding a partial view, leading to partial remedies. The appropriate criterion to assess implementation is whether market participants are actually affected by the liberalisation envisaged and the regulatory objectives adopted when crossing intra-EC borders, when respecting national legal provisions and in their day-to-day dealings with national administrations.

4.1 The roots of the implementation problem

Fascination with the high politics of Council decision-making tends to relegate implementation matters to a secondary level. Painstaking efforts to achieve proper implementation are not seen as very inspiring and receive little or no political credit at the moment. Attempts to push the issue higher up on the Community and national agendas risk running up against a lack of interest and prejudice about the 'mere' technicalities of the problem.

Such negligent attitudes are a matter of concern. It is critical that the roots of the implementation problem be much better appreciated by ministers and the national and regional administrations, so that some general remedies can be applied and a more systematic endeavour to pursue implementation can be forthcoming from the EC institutions, the member states and the private sector.

A large-scale multinational research project, led by the European Institute of Public Administration [1], preceded by work done by a group of political scientists [2], has improved our understanding of the problems and their roots. Consider the following stylised results from the case-studies:

A. There is a close relationship between the preparation and negotiation of Council legislation and the implementation of this legislation. Observe that, frequently, different ministries or sections are responsible for the first and for the second aspect. However, case studies show that a ministry's approach to implementation of Community law is more positive when they have taken part in its preparation. A special situation presents itself in Greece, Spain and Portugal as these countries had to implement a large body of Community law - in itself a major problem, perhaps insufficiently appreciated - without having taken part in its preparation.

B. member states posing problems during the negotiations are not necessarily the ones creating difficulties or delays during the implementation.

C. Unanimity not only renders decision-making more difficult; the quality of the directive also tends to be diluted. Quality can be measured on the basis of criteria such as coherence, simplicity and practical enforceability. There are indications that qualified majority voting (ceteris paribus) will facilitate implementation in that coherence and simplicity will be more easily achieved.

[1] *L'Europe des Administrations?* edited by Siedentopf and Ziller, European Institute of Public Administration, 1988.

[2] *L'application du droit communautaire par les Etats Membres*, edited by Ciavarini Azzi, European Institute of Public Administration, 1985.

D. Especially for the four relatively decentralised EC countries (Germany, Belgium, Italy and Spain), participation of, or at the very least consultation with, the regions is likely to improve the chances of proper and timely implementation.

E. Interest group participation derives its varying importance from the subject at issue. When important groups have been ignored, they can form a serious obstacle to implementation while in different circumstances they can be a driving force.

F. Member states tend to be ill-organised for the task of implementation. None of the member states (before 1985) had a powerful central authority in charge of coordinating the implementation. If one favours - as we do - having Community law 'absorbed' by the national structures as naturally as possible, one should nevertheless find mechanisms to ensure that the task is well done.

G. In most countries (except Italy until 1989) the main cause of delay of implementation of Community law cannot be sought in the intervention of Parliament. Perhaps one might go further, as sometimes suggested: national parliaments show little interest in implementation and enforcement, irrespective of whether one speaks about 'domestic' or Community law. (Note that this contrasts sharply with the attentive attitude of the European Parliament, which is a driving force in the implementation debate).

H. After incorporation into national law, application would seem to be neither better nor worse than national law.

It should be remembered that this research preceded the White Paper measures. Apart from the sheer quantity of intra-EC legislation involved in 1992 - indeed mostly in the form of Directives - some of the guiding principles of '1992' (see section 2.2.) may well generate new problems of implementation, the scope and economic impact of which is yet unknown.

4.2 Implementation and the single market

A recent Communication from the EC Commission (COM (89) 422 of 7 September 1989) addresses for the first time the 'implementation of the legal acts required to build the single market'. The more important conclusions are summarised here for the four layers of implementation:

4.2.1 Application of the Treaty

The Commission concentrates on the key Articles for the freedom of movement of goods, services, capital and persons.

- should the principle of non-discrimination, in Article 7, not be applied equally vigorously to People's Europe - i.e. the movement of persons, in this case - as it is already to the movement of goods? The right to residence of students is a test case here.
- Article 30 is of paramount importance for the single market. The Dassonville/Cassis de Dijon case-law has greatly helped to improve mutual access between member states. The 'mutual information' directive 83/189 complements the case-law by preventing new technical barriers from arising. Since April 1984 (when it went into force) some 800 or more national draft regulations have been notified and many of them have led to comments from other member states or the Commission. In numerous instances drafts are adapted so that the free movement of goods will not be hindered. There can be no doubt that 83/189 constitutes a very important instrument to make the single market function better. Nevertheless, in no less than 25 % of the notifications the Commission has to use a 'reasoned opinion' (and occasionally, propose an EC directive preempting the national draft), showing that the principles of Community law are not yet systematically being applied by the national administrations. Note that this point is likely to be a greater threat to the single market than the occasional improper implementation of an EC directive, as discussed in section 4.1., since the member states are still generating the bulk of technical regulation in the Community. However, even this unique example of 'monitoring and feedback' at the EC-member states' interface has its compliance problems as some member states notify better than others.
- a special category is the application of competition rules, especially state aid (see 4.3.).

4.2.2 Incorporation of Directives into national law

By early September 1989 only six out of 68 '1992' Directives having become applicable had been incorporated into the legislation of all member states. The latter had incorporated at best approx. 85 % and at worst 30 % of the 68 Directives. Apparently this message struck a sensitive nerve because a number of member states (' immediately notified the Commission (and the press!) that their implementation record was in reality much better. As regards their record on 'monitoring' and 'notification' - essential if one wishes to keep track of implementation as accurately as of the adoptions of the Council - these member states were sloppy or late. It is encouraging, at least, that no individual member state wished to be seen as the culprit for a loss of credibility of '1992'.

The Commission briefly mentions a few reasons for the delays, such as the absence of a monitoring structure in the administrations of member states (overcoming problem A. in section 4.1.), interpretation problems in difficult directives such as product liability and the mutual recognition of diplomas, and parliamentary procedures (which, as noted in 4.1., is a weak excuse).

4.2.3 Application of the 1992 Directives adopted

Incorporation of Directives, as well as adoption of Regulations and Decisions, is a necessary but insufficient condition for proper application. Improper application may be redressed by legal recourse (see below) but this is clearly a last resort for specific cases. The costs of incorrect application or non-application of '1992' legislation may be relatively high for individual persons and enterprises. If bad application practices spread, the credibility of '1992' will melt away very quickly.

One should distinguish two rather different sets of problems here:

- a very large number of technical 1992 Directives require adequate executive measures both at national and EC level. We refer to Directives about veterinary, plant health and agri-food issues as well as the Directives under the 'new approach' of technical harmonisation. Essentially these are management issues and the problems with it are likely to be temporary. Yet it should be stressed that the scope and magnitude of the management issues are tremendous. Unfortunately, both in the public and the private sector, these executive issues are widely disregarded because of ignorance or lack of interest. There is a risk that the satisfactory progress precisely in these fields is built on shifting sands.

  In food the executive issues have not been delegated to the Commission, with the absurd consequence that the Council is now faced with the task of taking perhaps as many as several thousands of decisions on additives, colourants, preservatives etc. In industrial technical harmonisation, mutual recognition of tests and certificates in the framework of Directives with health and safety aspects requires confidence building between many institutes with respect to independence, competence, professional capacity, transparency of their facilities, etc. Note that the beginnings of a European approach to these questions were only made in June 1989 when the first major Commission proposals were published. With respect to the 'new approach', reference to European standards presupposes the existence of these standards. Although legally one may temporarily employ national standards, the frequent inconsistency of national standards causes 'mutual recognition' to be of little help so that a considerable degree of fragmentation persists too long. There is also a knock-on effect for testing, since a standard will usually describe the proper criteria and test methods.

This is not meant to repudiate the 'new approach'. Quite the opposite, only when the full consequences of the 'new approach' are accepted will it achieve the desired liberalisation and large efficiency effects in the goods markets.

- incorrect or inconsistent application of Community law, based on insufficient acquaintance with it, on misunderstanding or on simple ignorance. A notorious case is the long struggle to achieve a common interpretation and application of customs rules.

4.2.4 Effective legal recourse

Community law is firmly entrenched in national legal systems by means of the doctrines of 'direct effect' and 'supremacy of Community law' as well as through preliminary rulings and infringement procedures. For the market and the individual citizen, what counts is how efficient, rapid and effective legal recourse is expected to be in cases of bad application, non-implementation, suspected discrimination and various forms of non-compliance. Here too certain preoccupations have emerged. They will be discussed separately in section 5.

4.3 Improving implementation: some proposals

In COM (89) 422 the Commission proposes a number of remedies. We shall discuss the proposals in this section. The following proposals relate to the first three layers of the implementation problem (for proposals with respect to complaints and legal recourse, see section 5). We shall group them in six categories.

4.3.1 Information

It almost goes without saying that information about implementation is grossly insufficient. If the member states hasten to say that they have implemented more than the Commission report states, it simply means that even the Commission is not notified in time. One can only wonder what the level and quality of information is *between* the member states about everyone's implementation — common interest in a common market! — or, for that matter, the information which reaches business, let alone consumers and small traders. In this regard adequate information is a Community task par excellence. Until 1989 it was largely the insistence of the European Parliament which prompted the EC Commission to begin reporting about it (after 1983) and to improve these reports gradually (see e.g. the sixth report to the EP, COM(89) 411 of 21 December 1989).

The Commission is involved in four initiatives: every six months a report on implementation of '1992' measures will be published; the *CELEX* data base of the Commission on Community law, accessible to the public, will give information on the state of implementation (we suspect, in the sense of 'incorporation into national law'); from early 1990, the special INFO 92 data base will carry the same information about incorporation; and in the special case of Directive 83/189, the list of notifications has been published regularly since 1989 for, as the Commission puts it, 'the benefit of economic operators'. Henceforth, therefore, it should be easier to monitor implementation and to query every administration, including at source.

4.3.2 Preventing infringement: a cooperative strategy

Rather than maintaining an artificial distance between the Commission and the national administrations *after* adoption, until a case of infringement arises, it would seem less costly for economic operators and help the functioning of the internal market if a permanent dialogue and occasional concertation between the two levels could be developed, without undermining the duty of the Commission to act as a 'guardian of the Treaty'. For this purpose the Commission is undertaking three initiatives:

- after every adoption of a 1992 Directive it will send a reminder about implementation to national administrations.
- it will use the concertation procedure of Directive 83/189 for joint examination of progress made on draft measures implementing technical harmonisation Directives, especially those of the 'new approach';
- it will hold expert meetings about interpretation problems in difficult Directives.

In addition, the suggestion has been made to have a contact person in each member state within the existing coordination structures with responsibility for maintaining implementation.

4.3.3 Facilitation through transparency

For historical reasons (e.g. the 'old approach' of technical harmonisation, with separate Directives for every 'aspect'), and because of one-time political compromises, EC law is sometimes excessively complicated. This is further complicated by Commission (not Council) Directives, amending the texts for reasons of technical progress. Hence a policy of enacting 'consolidated' texts for public works, public supply contracts, for the seventh VAT Directive, cosmetics and tractors is being pursued.

The sector where this is most needed (cars, with no less than 41 Directives, dealing with 'aspects'; trucks also have a dozen or more) is not mentioned by the Commission. The blockage by e.g. France to adopt the last three 'old-approach' Directives, so as to consolidate the combined tests and enable EC approval for a car, hinges on solving issues of Japanese exports to the EC. In fact, in the car sector 'optional' harmonisation has been applied as well, which is confusing and costly - it retards the adjustment to the single market and should be terminated.

4.3.4 Management issues

Apart from the worrisome question of the 'refusal' of delegation of executive power to the Commission in the case of food, the great challenge for the single market is the 'new approach' to technical harmonisation. Technical barriers take three forms: technical regulations (mandatory, public interest); standards (voluntary, private agreements); and certificates and tests (mandatory or not, dependent on the case).

The new approach greatly lightens the burden of Council (quite apart from the introduction of qualified majority voting) by concentrating on the *objectives* of health, safety, consumer protection or the environment in a Directive, and subsequently referring to (in principle, European) standards written in such a way that national authorities are held to 'presume conformity' with such objectives. In other words, only rarely does the Council still specify the detailed (and not just the 'essential') requirements in a Directive! This is now limited to cases where, for reasons of health and safety, or because of too great an effect on the environment and competitiveness differentials (as in the case of vehicle-exhaust emissions) no optional conduct of enterprises is allowed, other than precisely specified. But in many other instances, the Directives will concentrate on the 'essential requirements' of health and safety and refer to European standards. European standards are still few. CEN and CENELEC traditionally had a safety orientation, to the extent that they wrote standards with a eye to legislative purposes at all. CENELEC has a reasonable record because of the work under the Low Voltage Directive of 1973, even though the programme ahead will be very demanding. Until recently, CEN had no European tradition. This collective of national standards-bodies was founded to coordinate European views in ISO, the world standards organisation in Geneva. Between 1975 and 1984 a slow process of conversion took place. With the 'new approach' the position of CEN has become essentially the same as that of CENELEC for the Low Voltage Directive: CEN has to write a large volume of European standards to make the 'new approach' Directives work in practice, i.e. to prevent business and consumers from slipping back to different national standards for a transition period. Measures have been taken to promote European standardisation: CEN moved to qualified majority voting and the possibility (in the second instance) of a separate EC vote; notification of draft standards of national bodies has greatly improved and is coordinated and published by a central unit of CEN/CENELEC; mandates of the Commission, with payments, help spur specific standards-writing; the budget of CEN has been enlarged.

Solving two important questions will greatly contribute to timely European standardisation. First, improving the institutional set-up would help. Apart from CEN and CENELEC, there is ETSI, the telecom standards institute. Whereas CEN and CENELEC are composed of national bodies, ETSI is European-wide, with open membership (for suppliers and users, EC and non-EC) although national telecommunications bodies still play a major role. Making CEN and CENELEC less dependent on the national bodies would greatly improve their capacity to respond rapidly and effectively. Such a single European structure, both vertically and horizontally, tying in other specialised (sectoral) standards activities only weakly or not yet linked to CEN, would enable the 'new approach' standards programme and other programmes to speed up by reducing duplication between national bodies as well as between the European and the national level. Even though standards-writing at CEN/CENELEC has increased fourfold in half a decade, the absolute totals are feared to be insufficient for Directives such as machines and building products.

Second, concerning implementation hinging on European standards, it is ultimately the scarce resource - the technical industry expert - who is decisive for the quality and quantity of the outcome. There are two aspects to this. One is that scarce expertise is wasted by frequently using the same person twice, at national and at CEN level. Moving towards a single structure could prevent this waste in many cases through joint programming, and by linking more strategically the notification of national draft standards to standardisation needs at CEN level. The other aspect is that, in industry, standardisation is neither viewed strategically nor as a crucial investment. There are exceptions (e.g. consumer electronics; IT hardware and software). Standardisation is clearly a major field where it is the *private sector* which should invest in implementation. This should be supported widely in Europe by improving the understanding of the economic significance of standards, especially by linking it to the single market, to a policy of quality control and global competitiveness.

Top management should encourage standards activities, avoid putting off intra-firm standardisers by isolating them from production and marketing efforts, and communicate with them on strategic and quality aspects. To a considerable degree, the accomplishment of the single market will depend on industry's attitudes and efforts in the standards field.

Another condition for getting rid of technical barriers is the emergence of appropriate, Europe-wide sectoral cooperation in the field (read: mutual recognition) of certificates and tests. The key words here are 'confidence' and 'employment'. The CENELEC Certification Agreement has shown that confidence presupposes strict conditions, openness, exchanges and regular contacts. Nevertheless, the fears of a shake-out or, alternatively, of numerous take-overs of testing institutes and laboratories in a process of rationalisation may provoke some rearguard action. Both key words therefore require attention, without which a mere paper structure of a European Certification Council would emerge without any cost reduction or genuine quality effect in the single market.

4.3.5 Broadening the civil servants' perspective

At long last the Commission is going to promote multilateral exchange and training programmes. For the customs this is long overdue. In 1989 the EC Commission proposed the MATTHEUS programme for exchanges between member states' customs services and between national services and DG XXI. In the implementation report the Commission suggests developing special courses for officials of national and regional administrations and promoting exchanges within the framework of the European Institute of Public Administration (EIPA - where all member states and the EC Commission are represented on the board). At bilateral level a few exchange programmes also exist but there is as yet neither any systematic effort nor funding at member states' level nor is there an explicit Community purpose in bilateral exchanges. The national institutes for public administration should, together with EIPA, go beyond institutional courses on the Community and lay more emphasis on specialised training in substantive EC

law, which forms the foundation of the single market.

4.3.6 The EC level as a remedy?

The principle of subsidiarity has the great virtue of respecting local values and preferences as much as possible and thereby avoiding any superfluous centralisation. In diverse and pluralistic Europe the principle is absolutely vital for the political success of the Community. In cultural and economic terms our diversity is a great asset, a rich source of experiment and inspiration and a permanent laboratory of alternative approaches and solutions. However, this does not mean that subsidiarity permits just any deviation in implementation without regard to the functioning of the internal market. The ineffectiveness of decentralised measures at the regional or national level constitutes precisely the argument for shifting their decision-making and, if necessary, even their implementation to Community level. It is therefore up to the member states to ensure such a level of implementation that subsidiarity does not lead to a shift of implementation to EC level, so as to avoid continued 'costs of non-Europe'! Member states cannot be sloppy about implementation and application while simultaneously insisting on subsidiarity as a key principle to achieve '1992'.

There are several ways in which a relatively limited shift towards the EC level could be envisaged. We shall briefly discuss three approaches. On all three, member states display inhibitions. The point to stress is not that member states are necessarily wrong in their justifications but that, if they reject a marginal shift to the EC level, they should simultaneously present a convincing case to make the single market function well despite decentralisation.

A first approach is to reduce the need for complicated and cumbersome harmonisation by a greater direct reliance on progressive interpretation of Treaty principles with respect to the single market. The Commission proposes much greater flexibility in guaranteeing equal treatment with nationals to all citizens of EC countries in the exercise of a professional activity. For the public sector it has proposed to open up functions in commercial services, teaching, health and certain research activities. In the private sector the real problems of non-recognition of professional qualifications are even greater. Another instance is found in the idea of accepting a 'Cassis de Dijon' kind of interpretation of Article 59, EEC, on the freedom to provide services (other than in transport, financial services and telecommunications).

A second approach is to shift the balance in the implementation of competition policy with respect to mergers and state aid towards a Community approach. For mergers the shift was finally recognised by adopting the mergers regulation in December (see 3.2.1.). For state aid the problem is quite different. The formal competence of the EC Commission has long been recognised. Decades of Commission surveillance of state aid have provided a rich history, ample experience, a number of Court cases and a better acceptance of the notion that subsidies can seriously distort intra-EC competition. Nevertheless, the political and social resistance against a strict EC policy on national and regional public aid, especially in the case of public enterprises, has rendered the policy less effective than the anti-trust policy under the Articles 85 and 86. In the first survey on state aid in the EC, rather shocking overall data on subsidies in member states were presented for the first time. In the years 1981-86 an average annual spending of Ecu 82 billion (3 % of GNP) was recorded, not counting the Ecu 22 billion provided by the EC itself (largely agriculture). A very large share of these amounts is composed of defensive subsidies, propping up ailing firms or even sectors, slowing down adjustment and hence ultimately economic growth. There can be little doubt that state aid in some sectors has distorted, if not seriously discouraged, intra-EC competition. A failing state-aid EC policy undermines the rationale for making and exploiting one internal market. Problems with aid via public enterprises, direct and indirect, with cross-effects of different types of aid, persist: aid in the car, steel (still!) and shipbuilding sectors; various types of aid in the energy sector (such as coal); and the incompatibility between an emerging internal market for energy and the distorted price regimes upheld by (cross-) subsidisation and even with (proper) notification of aid schemes. These problems make it clear that applying the general principle of subsidiarity may engender excessively-high costs for the internal market. Under such circumstances a stricter surveillance causing a shift in the EC/member states interface is justifiable and in everybody's interest.

A third approach is more institutional. Why not prevent all the implementation problems with Directives and enact more measures by means of Regulations, especially as Art. 100A provides the legal basis to do so? There are good reasons to be cautious here. The sensitivity of member states on this point can be traced to the loss of national parliaments' power to intervene. Thus, the fourth Declaration attached to the Single Act explicitly stresses the use of Directives, in case harmonisation should lead to adoption of national legal provisions. Perhaps as a consequence, the Council has rejected the use of Regulations for the veterinary and agri-food sectors. Moreover, the difference between Regulations and (detailed) Directives is frequently not great and, in any event, already a source of controversy among lawyers and among certain national legal bodies for many years. A Regulation may still require certain incorporation measures (e.g. the EEIG in company law), whilst the third and fourth layer of implementation, discussed in section

4.1., will not be fully resolved merely by altering the legal instrument. On the other hand, as section 4.2. shows, an emphasis on Directives places a great responsibility for the proper functioning of the single market on the member states.

5. Preventing disillusion: complaints and legal redress in the single market

The 1992 programme gains credibility when complaints are genuinely pursued and legal redress is fast and cheap. Thus, even if implementation is sloppy and results in *de facto* discrimination, rapid correction and feedback should restore business/or consumer confidence.

This is the fourth layer of implementation. Supervision of implementation can be effected by the EC Commission, member states and individuals and enterprises. We exclude here questions of a 'failure to act' (ex. Art. 175) where other EC institutions but also individuals under certain circumstances have the possibility to bring a case before the EC Court of Justice (e.g. the European Parliament on the failure to construct a common transport policy). It will be assumed that member states and the EC Commission only act on complaints, an assumption which is likely to be close to the real situation (except in cases of environment and taxes) if only because no adequate overall monitoring exists in the EC.

Table 2 provides a sketchy overview of the possibilities for business and citizens to seek legal remedies for suspected infringement by a foreign member state (the following draws heavily on Bronckers, 1989). The survey is not particularly encouraging for trade and industry keen to exploit the single market. For all the great economic prospects of the single market, given its incentives to companies and traders to encroach on other 'national' markets and Europeanise operations, the legal security for business would seem to lag behind the rapid integration in the framework of '1992'. What is so discouraging is that traders and business, and ultimately consumers, bear almost invariably all the costs of the infringement of a member state! This must considerably reduce incentives to go truly European in general and discourage companies (even unnoticeably!) from competing as aggressively as would seem possible in certain specific cases. Combining Table 2 with the annual Commission reports to the European Parliament on the application of Community law cannot be read otherwise than as a serious warning signal. Enforcement should be improved, remedies against infringements should become more effective *and the costs* (including damages) *should not fall precisely on those who act in the market spirit of 1992.* We do subscribe to the view that private enforcement is an important task for business in the framework

Table 2
Remedies against infringements by another member state
(for citizens and business)

form	in case of	addressee	costs	discretion - addressee	other drawbacks	effectiveness
informal	implementation of EC law by another member	own member state	low	M.S. can follow - informal bilateral diplomacy - ask the COM to start an 169, EEC infringement procedure - ask the COM to propose new legislation - a 170, EEC Court proceeding (rare!) - a no-action course	generally slow and without any guarantee	low to very low
proceeding in the national court of the M.S. concerned	EC law with 'direct effect'	foreign court (in an EC M.S.)	possibly very high	court can ask preliminary ruling from CJEC	- inhibition to litigate in foreign courts - inhibition to litigate against foreign government (esp. if potential client) - takes very long - damages almost excluded	- 'effectiveness' is not one of the min standards of the legal protection enjoyed - no or very late relief
request to COM to call M.S. to order	any (binding) EC law	Commission	low	- COM can use 3 bilateral stages of 169, EEC procedure - 169, EEC court procedure - COM may choose not to act (political, tactical)	- may take long - interim measures very rare - no procedural safeguards for companies	variable; very rarely direct relief

of 1992. The member states and the EC Commission cannot be expected to put in place more than the minimum conditions for the single market, at least not before 1993. Much of what follows will have to consist of private enforcement. However, this does require a greater prospect of success for such private actions.

Oddly enough, as Bronckers notes, procedural safeguards for a complaint to the Commission do exist in the New Trade Policy Instrument ENTP(I), dealing with third countries' trade practices. Is '1992' not much more important than the NTPI? Could not some or all of these safeguards be introduced for complaints about member states? In any event, no information is ever made public about the policy the Commission follows with respect to Art. 169, EEC. The European Parliament asked (Janssen van Raay report, see Document A2-438/88/B of 13 March 1989) to provide more clarity about the Commission's reasons for not bringing a case to Court or suspending it.

Table 2 does not speak about remedies against one's own country. The picture here is somewhat better as various inhibitions do not arise. Bronckers, after noting that more procedural safeguards for a complaint filed with the Commission would not greatly enhance the effectiveness of this approach, takes the proceedings before a national court as the basis for a plea for decentralised supervision of enforcement. The question is how possibilities of appeal in national fora could be improved. For instance, the 'new approach' Directives on toys and pressure vessels contain no provisions requiring the member states to provide legal remedies, or better, effective legal remedies.

In the liberalisation programme for government procurement a special enforcement Directive is included, however. It was adopted in December 1989. Four remedies were proposed in the draft Directive (see COM/88/733):

- member states must provide summary proceedings in which the award of the contract can be suspended;
- member states should be able to invalidate illegal requirements in the tendering process;
- a right to compensation of damages resulting from illegal acts must be available;
- The Commission has the right to intervene directly in national proceedings.

Although the last provision was rejected by Council - a rejection which unfortunately amounts to a disincentive to submit (costly!) tender offers, given the deep mistrust business has with respect to the fortress mentality in public procurement - the right to have damages compensated and the other two requirements have been retained. This is to be welcomed as a step forward especially in public procurement. Would not the 'new approach' gain in credibility if similar requirements about legal protection offered in national fora were introduced as well? Have not the costs of 'institutional and legal autonomy' of member states become too high already and is it justifiable that they are wholly borne by business (and citizens, occasionally) rather than by the offending member state? If minimum standards are legislated in EC law for technical harmonisation, financial services and social measures, should they not be introduced for legal protection, without, however, striving for anything nearing systemic harmonisation?

Viewing the problem of implementation from the Commission's point of view (as the guardian of the Treaty, ex Art. 155), the problem does not confine itself to the well-known infringement procedures on non-incorporation or bad application. Two other categories of problems present themselves: (a) in its fifth report to the EP the Commission reveals that, at the end of 1987, there were 58 infringements procedures based on Art. 171 (non-respect of a ruling of the CJEC by a member state), of which no less than 45 concern the single market; in the sixth report the Commission reports no less than 94 cases of non-compliance with EC Court rulings but is not clear on the number of infringement procedures opened; several instances of a *second* infringement procedure all the way to the CJEC are reported, 'however'; (b) on several occasions the European Parliament has expressed its concern about the (im)proper application by national courts and tribunals of CJEC preliminary rulings. In the sixth report (pp. 92ff) a study is presented showing that preliminary rulings are fought more and more frequently and that interpretation of EC law by national courts is improving greatly. One could add the even more problematic issue of failures to ask for a preliminary ruling by the national court of highest instance, where there is an obligation to do so. Again, a special study on this point in the sixth report (p.94 and the Appendix) reveals that these problems have decreased recently.

Of all these problems the one most worrying for '1992' is the failure to comply with the judgements of the CJEC. This is not just a matter of professional concern for lawyers; rather, it threatens to undermine the credibility of the internal market for business and consumers if national bureaucracies are seen as being above the law. One cannot leave the resolution of this deep-seated problem entirely to the Commission and the attentive European Parliament. Business and citizens will have to complain and force member states to do better; well-informed journalism may be useful. As of mid-1989 all draft directives contain a provision obliging member states to refer explicitly to EC directives in the relevant new legislation. Better and faster implementation is needed in all member states. The more 'common' our internal market becomes, the more our interest in proper implementation *throughout* the Community grows. It needs to be addressed now, not later.

6. Cooperation between administrations: a prerequisite for 1992

Far too little attention has been paid to administrative provisions or requirements in a rising number of '1992' directives. Although we are making one internal market, its rules are administered at two (or more) levels of government. The reliance on 'subsidiarity' in particular generates a great need for two forms of inter-administrative cooperation: vertical (on the EC-member states interface) and horizontal (between the member states). Both leave their respective competences and especially member states' autonomies untouched, whilst attempting to fill the 'management void' so as to make the internal market work better. Our discussion will be very brief. The object needs to be addressed after in-depth study and such work is not available. We shall however provide important reasons and provide major examples where such cooperation is critical to make the Single Market work.

6.1 Vertical cooperation

The EC-member states interface has traditionally been viewed, rather legalistically, in terms of competences. Moreover, regulations and very detailed Council Directives, frequently updated by technical Commission Directives, have often been adopted on the condition of the simultaneous establishment of a consultative or other 'committee'. In painful analogy with the old idea of total harmonisation, hundreds of technical and other directives have such watchdog committees. The vast and complex legislation programme of '1992' and beyond makes this a hopelessly inefficient and sluggish form of cooperation. Cooperation between the Commission (or other EC institutions, where relevant) and the member states should lubricate the executive tasks which follow from the principal political and legislative decisions to be taken at Council level. Proper execution must be goal-oriented. Since the goal is to make the internal market work, once the Council has spoken, committees should be instrumental to this goal. This implies delegation and a management perspective, not a view dominated by excessive fears about the 'loss' of (bureaucratic?) power. The key question of 'comitology', as this issue has been baptised, is therefore the following:

Is it a mere constraint on the powers delegated to the Commission or should it be used in a more positive spirit as an *effective management tool* for the numerous implementation problems on the EC-member states' interface? The obstinate attitude of member states in the case of harmonisation of food legislation and standards would seem to point to the former. Fortunately, there are other developments too.

The experience with the notification, consultation and so called *paquet* meetings with specialists of national administrations in the framework of Directive 83/189 demonstrates convincingly that cooperation can be highly beneficial in preventing many technical problems before they impinge upon the economic operators.

6.2 Horizontal cooperation

Once the EC legal framework is firmly established and harmonisation is sufficient, inter-member state cooperation is the key to the smooth functioning of the single market. Again, this is an issue where member states have to realise that '1992' is not only made in Brussels. Consider the areas where intense cooperation and permanent mutual information mechanisms are required, by virtue of directives already adopted, proposed or envisaged:

- VAT and excise;
  Whatever the solution, cooperation between member states will be intense. Surely, a clearing house presupposes more mutual trust between member states than the October 1989 concept does. Still, with open borders, cooperation (e.g. verification of documents at both ends of the trade) between tax authorities will be daily practice, and not incidental even if a very selective approach is employed.

- Insurance and banking;
  Extensive mutual information, with regular local visits of supervisors foreseen, are essential ingredients of the proposals. After all, the harmonisation concentrates on the soundness of financial institutions and to a lesser degree on financial 'products'.

- Controls on persons;
  Drugs, immigration, asylum policies, residence, hot pursuit of criminals (across intra-EC borders), policies on firearms, all require well-developed inter-member state cooperation. The Schengen accords (not signed yet) have shown that the principles can be hammered out. The executive cooperation still has to be learned, however.

- Veterinary and plant controls;
  Shifting controls inward presupposes mutual confidence in testing and adequate inland inspection systems, as well as sufficiently severe sanctions. This may also apply to inspection and controls of food more generally. These so-called technical matters should not be underestimated by politicians because consumer reaction can be very strong and subsequent national impulses might disrupt the single market in such products!

- Air traffic controls;
  The blatant unwillingness until the late autumn of 1989 to truly modernise the entire air traffic IT system, as well as to accept a sufficient degree of centralisation, is a permanent threat to the further liberalisation of air transport. One can only hope that the recent decisions finally overcome the antiquated system of physical fragmentation of what is in economic and air transport terms 'a common good': the European airspace above the Single Market.

If member states agree on the Single Market as they did in ratifying the Single Act, while insisting on the principle of subsidiarity, they will have to learn to cooperate with each other more intensively and in many more fields than is currently the case. A failure to do this would either undermine subsidiarity by necessitating further centralisation or negatively affect the greatest asset the Community can exploit: its emerging Single Market.

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Part III Panel Response

5 Response to Daniel Gros and Niels Thygesen, 'Concrete steps towards monetary union'

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It is difficult indeed for me to comment on the paper by Daniel Gros and Niels Thygesen as I agree with practically everything they say in their thought-provoking paper and could not say it any better.

However, since discussants are supposed to criticise authors, I will devote my remarks to problems Gros and Thygesen have *not* examined, as much as this may appear difficult to believe, given the broad coverage of the analysis and the length of the paper. I will examine the paper from the vantage point of a central bank official with daily experience in the workings of the European Monetary System and will therefore concentrate more on the operational implications of the paper than on its analytical content.

Before doing that, I will explain why I agree with Gros and Thygesen by recalling the main points of the Banca d'Italia position on the question of European monetary union. As I believe is well known, we consider monetary union not only a desirable goal but also a technically feasible one. As Gros and Thygesen recall in their paper, Governor Ciampi himself presented a note to the Delors Committee precisely to show how an operational framework for the conduct of a common monetary policy could be set up. The Ciampi scheme did not claim to be the only possible way for a European system of central banks to operate in Stage II; indeed Gros and Thygesen have convincingly shown that the same objectives can be achieved without a system of ECU reserve requirements imposed by the central monetary institution on national central banks, but instead through a system of uniform reserve requirements on the Community's commercial banks. A further elaboration of the Banca d'Italia's scheme has been made by a colleague of mine, Lorenzo Bini Smaghi, in a paper to which Gros and Thygesen also make reference and which examines the experience of the creation of the Bundesbank from the Bank Deutscher Länder.

To us, therefore, the paper by Gros and Thygesen provides additional confirmation of the fact that marching down the road to monetary union will not be hazardous to the health of European citizens and that it would be possible to set up instruments and procedures to effectively manage monetary policy in the transition. This is a very helpful conclusion, implicit in the Delors Report, that Gros and Thygesen have spelt out with great clarity and all the necessary details.

Having said that, I have only a few minor observations on specific points of the paper. Let me begin by addressing its conclusion, that a monetary union must involve a common currency, which I take to mean that it also requires a common monetary policy. On this point I would only argue, as in Governor Ciampi's paper, that if a common monetary policy is achieved, and exchange rates are irrevocably fixed, then the system may also operate with a plurality of currencies for a while.

The paper correctly points out that this would entail certain costs, but I would maintain that such costs are likely to be negligible if it is clear to market participants that the irrevocable locking of parities is strongly backed by an institutional framework for the conduct of a common monetary policy. Retaining for a certain period a plurality of currencies may, on the other hand, have the advantage of allowing the necessary gradualism in a change that would inevitably have a strong impact, over the long term, on the habits and behaviour of ordinary people.

Aside from this minor point, I generally concur with Gros and Thygesen's analysis of the costs and benefits of a monetary union and found particularly valuable their treatment of one of the most controversial points of the Delors Report, namely that related to the need for 'binding rules on budgetary policies'. On this my personal position is that although Italy would greatly benefit from an additional external constraint on its budgetary policies, in general terms I believe that Gros and Thygesen are right when they say that 'the fixed exchange rate system underpinned by a common monetary policy...would adequately constrain budgetary policies'. I also agree with them, however, that excessive budget deficits may threaten the credibility of the exchange rate commitment and that, therefore, some central control over budgetary policies may be needed. The most appropriate form for the exercise of such central control may be the multilateral surveillance to be conducted by the Ministers of Finance within the context of the revised 1974 decision on convergence. Depending on the experience acquired with multilateral surveillance during Stage I, the Council may want to adopt more binding and constraining procedures for budgetary policy coordination, as well as for the realisation of a consistent set of policies in the Community.

Finally, as regards monetary policy coordination in Stage I, I agree it will be difficult to realise much ex ante coordination in the present institutional context. However, I would not underestimate the potential gains to be derived from the new initiatives under consideration in the Committee of Governors. In particular the proposals for the establishment of three subcommittees on monetary, exchange rate and banking policy and for an independent research unit for the

Governors have already elicited some interesting new ideas and promising suggestions for analytical work.

Let me now turn to what appears to me the major omission in Part II of the paper. I will say at the outset that the omission is more one of emphasis than of substance, but I still regard it as an important one.

The paper in my view understates the seriousness of the following problem: how long, or how short, should Stage I be if the entire process of moving towards economic and monetary union is not to be irreparably jeopardised? Gros and Thygesen discuss this problem almost in passing and indicate that Stage I should be as short as possible, although I must say I did not quite understand whether they think that it will entail a 'constructive feedback process' or that it 'may not be stable'. Be that as it may, the reader is left with the impression that this is a minor problem.

Let me explain why I also think that Stage I should be as short as possible, but am afraid of what may happen if that is not the case. Two important new factors analysed in the paper have to be put into a more realistic perspective. The first is the paper presented by the United Kingdom Treasury and the second is the open request by the German monetary authorities for an EMS realignment. Both events in my view are potentially destabilising for the EMS during Stage I, with the risk of prolonging that stage indefinitely. Let me explain why.

The EMS has now becomes a 'regime' in the sense implied by scholars of international political economy, namely 'a set of principles, norms, rules and decisions making procedures around which the expectations of international actors converge'. [1] This result has been achieved basically thanks to the well-known asymmetry described by Gros and Thygesen in their 1988 CEPS paper, but also because the process of European monetary integration has since 1985 seen a remarkable acceleration, which has not gone unnoticed by market participants. The elements of this process are well known: the Single European Act, the Community Programme of financial liberalisation and its punctilious application by France and Italy, the Basle-Nyborg Agreement, the decision by the Hanover European Council to set up the Delors Committee, and finally the unanimously-agreed Delors Report itself. For an economist these events may be difficult to quantify, but for a market participant, believe you me, they are factors with very powerful implications for the decisions of corporations, intermediaries, and private investors. The main as-

[1] S. Krasner (ed.), *International Régimes*, Cornell University Press, 1983. On the role of régimes in international monetary relations see also G. Gomel, F. Saccomanni and S. Vona, 'Tripolar economic policy coordination: problems of a multi-country pole', *Temi di Discussione*, Banca d'Italia, forthcoming.

sumption underlying those decisions has been that the zone of monetary stability in Europe was gradually evolving into a tighter, more closely integrated monetary union. In the view of market participants such a prospect dedramatised the existence of intra-EEC payments imbalances, leaving the same equanimity as that with which imbalances between Lombardy and Sicily, or between Normandy and Provence, are viewed. Such a picture has been reassuring not because those imbalances do not matter, but because market participants have felt that they would be addressed by appropriately-coordinated macroeconomic policies and not by exchange-rate adjustments.

Now, gradually but steadily, this scenario is changing. The Madrid European Council provided the first indication of an emerging impasse. More recently, as a result of the British and German initiatives, a new scenario is being unveiled to market participants - a scenario in which exchange-rate movements are again expected to play a major role in the adjustment of imbalances and the competition between currencies replaces the objective of the locking of parities and the establishment of a common monetary policy. In such a scenario, market participants are likely to be impressed by two main elements: one a divergence of views within the EMS as regards the role of Germany as the anchor of the system; two, the lack of a 'final goal' for European monetary cooperation. Both factors are likely to be interpreted as potentially destabilising for the EMS particularly in the context of the new environment of full capital mobility that will emerge no later than July 1, 1990.

If I may make reference to the well-known image of the inconsistent quartet developed by Padoa-Schioppa, I will say that the market is likely to draw from these factors the following conclusion: the member countries of the Community, after having realised an area free of trade restrictions, complete freedom of capital movements and stable exchange rates, have decided to go back on the latter because they are unwilling to relinquish their autonomy in economic policy-making. I am afraid that no communiqué, no matter how skilfully drafted, will convince the market that this is not so.

On the other hand, an early decision to call the mooted intergovernmental conference would be likely to be interpreted as a sign of renewed determination to proceed towards a common monetary policy and monetary unification. I am not claiming that the announcement of the beginning of the work for a new treaty would solve all the problems now confronting the EMS. But the prospect of a new step forward in the process of monetary integration would provide an environment conducive to the orderly and cooperative management of these problems. This is not a new phenomenon: it is an implication of the 'spill-over effect' to which President Delors made reference in his opening address and which has manifested

itself before. Indeed the EMS has provided the framework for a strong disinflationary effort by most EEC countries; the Basle-Nyborg Agreement in particular provided the framework for handling the impact of the early measures of capital liberalisation in France and Italy and coping with unexpected situations of financial turbulence such as the stock market crash of October 1987. In the same way, the preparation of a new treaty could provide the cooperative framework for handling the problem of the German current account surplus while preserving monetary stability in Europe.

I have perhaps been carried away by my own feelings of central banker and market participant and I have perhaps gone outside my task of discussant of an otherwise excellent paper. But I felt that the paper projected, perhaps inadvertently, too rosy a picture of the environment in which the concrete steps to monetary union are to be taken.

6 Response to Jacques Pelkmans and Peter Sutherland, 'Unfinished business: the credibility of 1992'

Hanns R. Glatz
Board Representative, Daimler Benz AG

I would like to make three remarks. The first relates to the question 'How to get the decisions to the market?' or 'How to create the Internal Market through the elimination of frontiers?'. The second addresses the problem of the role of industry: a driving force or a retarding factor? The third concerns the dimensions of the free market which industry endeavours to obtain.

1. How to create the Internal Market through the elimination of frontiers?

It should be stressed that the elimination of internal frontiers is not an end, it is only a means to achieve the large internal market, a harmonious economic area. In some cases the elimination of frontiers is combined with full harmonisation of regulatory requirements: European Type Approval for motor vehicles is a typical example. In other cases the elimination of frontiers is accompanied by deregulation: the liberalisation of cross-border road haulage from the existing quota system would be an example there.

In both these cases the development of harmonious conditions is the result of deliberate government decisions. In most cases, however, the process of establishing harmonised conditions will only start after governments have eliminated physical, legal, fiscal and administrative frontiers. In all these cases, harmonisation will be the result of the competition of systems (for example VAT or mutual recognition of national standards) and not of government decisions. In other words, governments will have to transfer sovereignty to market forces. This explains the reluctance of some governments to proceed effectively with the elimination of frontiers.

Of course, industry prefers the first two types of cases; there you know exactly what to expect. Industry is, however, also ready to accept developments of the third type, even if it is sometimes difficult to operate during the period of adjustment, while market conditions are often disturbed by system and rules differing from country to country. In any event, governments must live up to their commitments accepted in the Single Act and *eliminate frontiers*. Regarding VAT, for example, the solutions discussed at present fall short of this, because fiscal borders are maintained and only relocated inside countries. This is in breach of the Single Act and unacceptable to industry.

2. Industry — a driving force or a retarding factor?

Even prior to the Commission's White Book on the internal market, industry had stressed the importance of completing the internal market speedily. Industry has also adopted the habit of not waiting for national implementation of EC directives or other decisions. EC decisions are taken as the basis for business decisions — which, of course, can lead to difficulties if national governments either do not implement such decisions or apply them (for example, through tax incentives) at much earlier dates than laid down in the EC decisions. On the other hand, when confronted with continued distortions in an open market (for example, extreme differences in registration taxes for cars), the motor industry is not very enthusiastic about this market openness. How can one pursue a harmonised pretax pricing policy if the (tax-inclusive) customer price in one country is three times as high as in its neighbour?

3. Dimensions of the free market

Initial studies of the economic benefits of the Internal Market arrived at very optimistic conclusions. For example, the Cecchini/Ludvigsen study estimated an improvement in the price-competitiveness of about 5% for the EC motor industry. More recent estimates, including those by vehicle manufacturers themselves, do not fully support this figure.

This should not imply that the initial estimates were fundamentally wrong. However, in the meantime it has become obvious that due to the rapid globalisation of certain industrial sectors — including automobiles — the unification of the EC market was the absolute minimum required to avoid a deterioration in European industry's competitive position. This in turn explains why European industry strongly advocates the extension of the Internal Market to include at least EFTA and — more recently — possibly also some parts of the newly opened-up Eastern Europe. At all events, EC market integration — which must be pursued in its own right — must not become a roadblock to any later extension of economic and political integration with Eastern Europe.

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