NOTAT
NUPI
PAPER

Nr. 429 August 1990

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A cost–benefit analysis

norsk
utenrikspolitisk
institutt
nupi
norwegian institute of international affairs

ISSN 0800-0018

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ABSTRACT

The Delors report (April 1989) took the aim of an Economic and Monetary Union (EMU) as given and only outlined a strategy in order to achieve this goal. In spite of the fact that the EC countries have committed themselves to the creation of an EMU, none of the treaties signed in this respect has clearly defined precisely which features an EMU should consist of. Thus, since the costs and benefits will vary according to which definition you give of an EMU, the final decision on the features of the EMU to be adopted will depend on a political economy analysis of the costs and benefits expected to result from the establishment of such a Union. Accordingly, this paper first sets out to find an a priori definition of EMU upon which a cost-benefit analysis may be based. Since the concept of "EMU" is no novelty in the context of European integration a short history of the European Monetary Integration is given. Given the positive achievements of the EMS, the question is asked "why is there a need for further monetary integration?". The paper then outlines the different arguments that have been put forward during the debate since the Delors report was published. On the basis of a definition of EMU that is arrived at by recognising the necessary and sufficient conditions for the stable functioning of such a Union in a long-term perspective, a political economy cost-benefit analysis is performed with the aim of giving a qualitative assessment of the prospects of an EMU, and more precisely what the features of the Union are likely to be. This analysis takes into account that there are some gains and losses that are more general in character, i.e. affecting the whole of the EC in a more or less equal way, and that there are some gains and losses that will affect countries differently, i.e. creating relative distortions between the countries in the net gains (or losses) that occur through the completion of EMU.

Oslo, 1. august 1990

ABOUT THE AUTHOR

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C O N T E N T S

THE PROSPECTS OF AN ECONOMIC AND MONETARY UNION IN EUROPE -

A COST BENEFIT ANALYSIS

L'Europe se fera par la monnaie ou ne se fera pas.

(Jacques Rueff)

1. Introduction

The debate around an Economic and Monetary Union (EMU) in Europe arose primarily as a spillover effect of the progress towards the Single European Market (SEM). It was feared that without a move towards EMU the "acquis communautaire" would be threatened, and further progress towards the SEM would be made more difficult - if not impossible. The plans for an EMU were strongly supported by the federalists who looked upon them as a possibility to move towards a European Union by pushing for institutional changes. A first, and very important step in this direction was institutional changes related to monetary integration. Monetary integration has through the history of the EC been seen as the "voie royale", not necessarily towards political union, but at least towards closer economic and political cooperation (Tsoukalis, 1983) - today this is definitely true also for the former part of the statement. This has become all the more obvious with the recent developments in Eastern Europe. Demands are surging from all over Europe for a speeding up of the process of integration - the motivations differing somewhat [1], but no dissent regarding the means to be used: EMU. This has, of course, given the EMU debate a significant momentum, but the argument around it has also become primarily political, as opposed to economic.

This essay does not deal with EMU in extenso, but focuses on the monetary part of the plan mainly for the reasons given above. This is also the field in which the greatest controversies lie. Furthermore, due to the vagueness of the concept of EMU it has become increasingly obvious - through the debate on this topic - that an EMU will come about as a result of an evaluation of costs and benefits of the "monetary union" (MU) dimension of EMU [2].

Accordingly, the purpose of this paper is to analyse prospects for a MU on the basis of a political economy cost-benefit analysis. Four basic assumptions underlie this analysis:

(1) Monetary integration does not take place in a political vacuum, i.e. external factors (e.g. the value of the dollar) will influence the development and prospects for a MU;

(2) the history of European monetary relations has clearly shown the benefits derived from having a system of fixed exchange rates. Thus, the question of fixed versus floating exchange rates will not

[1] This is discussed in the last part of the paper.

[2] The "economic" part of EMU is perceived to be equivalent to the plans already embarked upon for the SEM, and the only "new" dimensions in EMU are those related to the plans for a MU.

be debated here;

(3) the process towards MU must be perceived to be a positive-sum game for the region as a whole considering both political and economic factors. Furthermore, purely economic considerations of the creation of a MU must indicate a gain (or at least no loss), if not in the immediate short-term perspective, at least in a long-term perspective; and

(4) each individual country must perceive that it stands to gain from a political economy point of view from the establishment of a MU, i.e. no country must feel it will be relatively worse off than under the current system. More specifically, in the case of MU, there is the perceived need for the power base of the system to become somewhat more symmetric.

The first chapter will give a short overview of the development of European monetary integration and the achievements of the EMS. Given this situation, the second part answers the question regarding the need for further monetary integration. The third chapter assesses the necessary and sufficient conditions for a MU to exist. These conditions form the basis for the political economy cost-benefit analysis. This analysis is again divided into a general and a country-specific part for reasons that are given in the underlying assumptions.

2. Short history of European monetary integration

The purpose of this chapter is to show that plans for EMU (and MU) are not new in the European context, and, to set the current debate into a certain perspective, as there might be certain lessons to draw from history.

The Treaty of Rome (EC, 1987) - signed in 1957 - did not call for creation of any form of EMU although articles 103-109 did call for unrestricted currency convertibility, abolition of restrictions on capital movements, and the coordination of economic policy. On the background of an analysis of these articles, Swann (1988) draws the conclusion that the "EEC did not envisage a centralised control over micro-economic management". However, he continues, "it was clearly recognized that economic integration gave rise to increased economic interdependence, and to that end the Treaty emphasized the need for consultation and coordination" (p. 176). In 1969, at the Summit meeting in the Hague, the heads of state decided to start the work towards an EMU. Swann points to three underlying motivating factors. Firstly, the wish to secure the achievements of the EEC [3]. Secondly, the national interests were perceived to be best taken care of through fixed exchange rates, albeit for

[3] This was mainly, but not exclusively, aimed at securing the free movement of farm products through more stable international prices. Thus, the good functioning of the CAP was one of the major reasons for the claims for fixing of exchange rates and eventually monetary unification.

highly differing motives [4]. Thirdly, it was thought that the move towards EMU would signal the will among the EEC countries to move towards a full political union and that in fact it would be a concrete step in this direction (Swann, op.cit.).

As a first result of the Summit meeting a committee was set up to evaluate the problems involved in pursuing EMU. The committee - chaired by Pierre Werner, Prime Minister of Luxembourg - delivered its report in June 1970. The report laid down a program for an EMU to be created by 1980. It called for a single community currency (i.e. irrevocably fixed exchange rates); the complete liberalization of capital movements within the EEC; a common central banking system, and a centralized economic policy-making body accountable to the European Parliament (Schinasi, 1989; EC, 1970). However, the initiative was aborted already from the beginning mainly as a result of the breakdown of the Bretton Woods system upon which "the Europeans were trying to build their own construction [...]." (Tsoukalis, 1983; p. 119). Furthermore, the two oil price explosions in the 70s were not "conducive to ambitious monetary objectives" (Brittan & Artis, 1989; p.4). Stephen George (1985) argues that one of the reasons for the failure of the Werner plan was major conflicts between France and

[4] E.g. for France the most important was the good functioning of the CAP from which it had much to gain. Some of the smaller states - with highly open economies - saw the possibility to decrease their vulnerability to events in other states working through the exchange rate mechanism, by introducing a fixed exchange rate system.

Germany when it came to the practical implementation of the scheme [5].

The main outcome of the process that started in 1969 was the creation of the "snake" in 1972. Whilst the Smithsonian agreement proceeded to widen the margins of currency fluctuations to +/- 2.25% (i.e. a total margin of 4.5%) as opposed to the +/- 1% during the Bretton Woods period, the EC countries decided to limit their margin to 2.25%. Hence, the "snake in the tunnel". This arrangement was, however, of limited success, due mainly to the tumultuous economic conditions prevailing throughout the 70s [6].

In 1977, Roy Jenkins, President of the Commission, made a strong plea to the member states to reconsider the idea of an EMU. The idea - although it came as a surprise to many - was taken up by Chancellor Helmut Schmidt and presented to the Summit in Copenhagen in April 1978. This unilateral initiative turned into a Franco-German plan after Schmidt gained the support of President Giscard d'Estaing. This plan was submitted to the Bremen Summit in July

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[5] The French, according to George, wanted to institute a system for mutual support of the fixed exchange rate system, expecting this to subsequently produce economic convergence. The Germans, on the other hand, claimed that the convergence of economic policies had to come first, and that their monetary policy - seeking monetary stability - should prevail over the common economic policies.

[6] For a comprehensive assessment of the functioning and development of the monetary system in Europe at that time, see Tsoukalis (1983).

1978 [7]. This was the birth of the EMS, which came into operation in March 1979. According to Thygesen (1987), the outcome could be seen as essentially an enlargement of the snake to include three new members - France, Italy and Ireland - and an extension of the "fairly undemanding practices of the snake in permitting relatively frequent realignments" (p. 164). The main features of this system have been the exchange rate mechanism (ERM), the European Monetary Cooperation Fund (EMCF), and the European Currency Unit (ECU) [8]. The EMS has now been functioning for 11 years and its success is widely acknowledged.

3. Achievements of the EMS

There is an extensive literature analysing the achievements of the EMS, and this paper will therefore only point to the main achievements as analysed by some prominent authors. It is important to have a clear view of the achievements before we proceed with a discussion on the need for further monetary integration.

First and foremost, the EMS has achieved its primary goal, namely that of stabilising the currencies against each other. The system

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[7] For further details on the creation of the EMS see Ludlow (1982).

[8] For a comprehensive discussion on the functioning of the EMS, see "L'Europe des communautés", Notice 10, Les notices de la documentation francaise, Secretariat General du Gouvernement, Nancy, 1989.

is one of fixed but adjustable exchange rates, taking account of the need for periodical realignments. The need for such realignments is a result of divergence in underlying real economic variables. The number of realignments within the EMS has been relatively moderate, with realignments occurring much more often in the first years of the system than during the last 4-5 years. Only one major realignment has taken place during the last three years (Harrop, 1989). According to McDonald and Zis (1989), the volatility of intra-EMS exchange rates - both nominal and real - has declined sharply since the creation of the system. Gros (1987) presents statistical evidence to indicate that exchange rate volatility within the EMS has been reduced to the minimum possible, taken into account the variability of the fundamental determinants of the exchange rates.

The reduced exchange rate volatility among the EMS countries must also be seen in light of the strongly fluctuating value of the dollar in the 80s. It then becomes apparent that the system has achieved another of the fundamental aims of the system, namely that of insulating the European currencies from the vagaries of the dollar. More generally, the system was able to resist external shocks occurring through the 80s (Padoa-Schioppa, 1987).

Furthermore, the EMS countries have seen a decrease in the level of inflation in all the member countries as well as a convergence of inflation rates towards a common low level [9] (Mcdonald and Zis, 1989). However, some authors have questioned to what extent this development really may be attributed to the EMS and not other - more external - factors. Giovazzi, Giovannini and Collins (1989) conclude on the basis of different comparative analyses that evidence in this direction is rather weak. De Grauwe (1987) shows that inflation rates fell more sharply in countries outside the EMS and at lower costs in terms of foregone growth and investment.

Most authors seem to agree that the EMS has contributed to convergence of economic policy. This may be exemplified explicitly through the collective character of the decisions regarding changes of the intra-EMS exchange rates. Implicitly it could also be illustrated through an analysis of the member countries' money supply growth rates. These have been declining and converging since the system was created (McDonald and Zis, op.cit.).

4. Why further integration?

Although not officially stated in the signing documents, the EMS was perceived by many as a first step towards a MU. However, neither de facto nor de jure steps in such a direction were taken

[9] Average inflation fell from 11% in 1980 to 2% in 1986, and the difference between the highest and lowest inflation rates narrowed from 16 to 6 percentage points.

until recently: The signing of the Single European Act (SEA) [10], by the EC member states, committed them to the aim of achieving some sort of EMU (article 20, EC, 1987). This aim was given further substance at the Summit meeting in Hannover in June 1988, when the aim was reconfirmed, and it was decided to set up a committee with the mandate to propose concrete steps towards an Economic and Monetary Union. The Committee was chaired by the President of the EC commission, Mr. Jaques Delors. The Delors report (EC, 1989), completed in April 1989, was presented to the EC summit meeting in June the same year.

Given the largely positive achievements of the EMS in creating a zone of monetary stability through a fixed but adjustable exchange rate system (ERS), why is it seen as necessary to go further in the integration process?

The first major reason given, was the strains that the EMS in its present conditions would be subject to through an increased liberalisation of the capital markets. With all restrictions on the movement of capital to be removed by July 1, 1990, [11] many scholars have predicted this to lead to an increased volume of speculative capital flows which would put the fixed ERS under

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[10] The SEA (EC, 1987, op.cit.) was signed in February 1986 and entered into force on 1 July 1987.

[11] Except for Greece, Portugal and Spain that have until 1993 to undo all their barriers on capital flows.

strain (Padoa-Schioppa,1983) [12].

The Padoa-Schioppa report (op.cit.) - published a year before the Delors report - only taking account of the purely economic challenges to the system analyses three different strategies for the development of the EMS:

(1) Status quo;

(2) loosening; and

(3) strengthening of the EMS [13].

The argument presented against the first option focuses on the danger of increasing size and volatility of the speculative capital flows created by increased capital mobility. Improved information in the capital markets might weaken the effectiveness of market interventions and thus provoke demands for further realignments [14]. McDonald and Zis (op.cit.) have argued that the EMS is well enough equipped to counter the challenge posed by the increased capital mobility "provided that inflation rates and their

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[12] The increased size of capital flows would lead to the need for large foreign currency interventions in the markets to defend the value of the currency (as confirmed in the days before the realignment in January 1987).

[13] This does not necessarily mean an EMU, but would mean at least fewer realignments and coordination of monetary policy. EMU was not seriously considered because the report was concerned with a minimalist approach.

[14] For further discussion on these mechanisms, see Padoa-Schioppa (op.cit.).

convergence are maintained at their current level" (p. 199). Padoa-Schioppa (1990), however, counters this argument in a leaflet published by the Group of Thirty. He there points to the fact that although inflation differentials have been reduced and growth performance improved, payments imbalances in the EMS have widened. Moreover, large and rather constant interest rate differentials do point to a lack of sufficient convergence in monetary policy and performance. Padoa-Schioppa states that managing the EMS would become more difficult with free trade and full capital mobility in the Community. Divergences and imbalances could build up, eventually losing credibility for the system.

A loosening up of the system might be achieved either by adopting wider margins of fluctuations or by resorting more frequently to realignments, or a combination of the two. This would probably have only an insignificant impact on trade imbalances while widening inflation differentials. This would clearly not be a development in accordance with the aim of the general economic integration in the EC, and more specifically, with the plans for the SEM. Adoption of the second option would be equivalent to foregoing the benefits that are yielded by a fixed ERS as well as making it impossible to achieve a fully integrated European market.

Following the above arguments Padoa-Schioppa (1987) arrives at the conclusion that the only viable solution for the EMS is to go for the third option - strengthening of the EMS [15].

The second argument is termed the "currency substitution" thesis and was presented by Gros and Thygesen (1988) in a pamphlet edited by the CEPS. Full liberalisation of capital movements and financial market integration will create the progressive need for monetary policy coordination well before the decision to fix exchange rates irrevocably. The reason for this being that non-residents may begin to use national EMS currencies for transaction purposes. This would undermine the possibility for the national central banks to maintain their monetary target objectives. More specifically, this development might threaten the D-Mark's position as the nominal anchor of the system. This is the main theoretical argument in the Delors report (op.cit., point 24).

However, there are further - more politically loaded - arguments pointing in the direction of the need for further monetary integration:

There is increased discontent among several (if not most) EC countries with the asymmetric [16] functioning of the present

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[15] This was what the heads of state opted for at the summit meeting in Madrid (June 1989) when they adopted the first stage of the Delors report. This first stage is nothing but a strengthening of the existing EMS.

[16] The term "asymmetry" refers to the de facto leadership of the Deutsche Bundesbank in determining the monetary policy to be pursued by the ERM countries. This makes it necessary for the other

system. The monetary policy pursued within the EMS is de facto that of the Bundesbank. According to Tsoukalis (1989, op.cit.), the reasons for this asymmetry are basically twofold: The German low propensity to inflate and the international role of the D-Mark. The former, combined with the economic weight of the country and the priority attached until recently in the other EC countries to the fight against inflation, has enabled Germany to set the monetary standard for the other countries. On the other hand, the increasingly important role of the D-Mark as an international reserve currency places the Bundesbank in a key position with respect to the external monetary policy of the EMS as a whole. This discontent with the present state of affairs is closely linked with the kind of monetary policy pursued by the Bundesbank, i.e. the anti-inflationary focus of that policy. It is perceived that this policy has had a contractive effect on the EC countries' economies, and thus, had a negative effect on employment [17].

Padoa-Schioppa (1988) more generally stresses that the lower inflation achieved through the consolidation of the system has made

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ERM countries to adapt to the policy pursued by the Bundesbank if exchange rates are to be kept stable. This clearly points to an asymmetry in the need for interventions in the market.

[17] The asymmetric functioning of the EMS has been strongly challenged by De Grauwe (1988) and Fratianni and von Hagen (1988). From the analysis of differing empirical evidence, they find little evidence for this hypothesis. However, the argument is still seen as important among several of the EMS-countries, and cannot be discarded.

consensus more difficult to achieve on monetary objectives. This is because national priorities may tilt in favour of growth in some countries and away from it in other countries. This poses a serious challenge to the EMS [18]. Several countries would like to see a change in the focus of the monetary policy in Europe, and they see the establishment of an EMU - in which they would gain more of a say in formulation of a monetary policy - as a means to achieve that [19].

A potential threat to the system also lies in the possible future depreciation of the dollar. This may endanger the cohesiveness of the system (Dornbusch, 1988) [20]. The strong dollar has been one of the factors that have kept the system together. Tsoukalis (1989, op.cit.) argues that a further weakening of the dollar might contribute to "increased tensions between strong and weak EMS currencies" (p. 65).

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[18] Such an erosion of the ideological consensus was perceived to have been one of the major reasons for the breakdown of the Bretton Woods monetary regime.

[19] For further literature on the concept of asymmetry within the EMS, see amongst others Tsoukalis (1989), Thygesen and Gros (1988), McDonald and Zis (op.cit.), and Schinasi (1989).

[20] A dollar depreciation - or expectations of such - will lead to a capital flight from the dollar to "safer havens", e.g. the YEN and the D-Mark. This will create strains on the internal exchange rates of the community, which again might lead to claims for realignments. Actual depreciation will, furthermore, influence the external trade position of the EC countries, and might, therefore, lead to claims for a change in monetary policy, which in light of the current asymmetry will lead to strains on the system. For further discussion see Swann (1988).

The de facto most important motivation for pushing through with the plans for an EMU (and more specifically MU) is related to the recent developments in Eastern Europe. There is a general "fear" among the other EC countries that rapid progress towards German reunification may divert German attention from the process of European integration. The fear is that Germany might turn inwards and start using its increasing economic might for its own domestic purposes instead of using them in an all-European framework, and for the benefit of increased cohesion within Europe. (The fear is not only related to the economic dimension, but also to a large extent to the security dimension and the prospect of a neutral Germany in Europe). The Germans on their side are trying to calm these fears by issuing various statements on their European commitment [21] and consulting their allies in EC and NATO before taking any major steps. However, most of the EC states would feel much more comforted if they could get the integration process one important step further by arriving at an agreement on the establishment of a MU to which Germany would wholeheartedly take part. This is possibly the most important motivation behind the plans for MU, and some have characterised it as a "make or break" point for further integration in the Community [22]. I will come

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[21] In February Chancellor H. Kohl issued a statement that he would consult the EC and NATO countries during the integration process. And Foreign Minister H. D. Genscher also expressed that "We wish a European Germany, not a German Europe" (Aftenposten, 1. March 1990).

[22] Expression used by Mr. John Stevens MEP in a hearing by the House of Lords' select committee on the EC (House of Lords, 1989, Paper 3-1).

back to this point when analysing country-specific costs and benefits.

The potentially disruptive effect on the current EMS system of the establishment of a GEMU (German Monetary Union), is another motivating factor behind the increasing momentum given to the plans for a European MU. The current EMS is fundamentally dependent on the nominal anchor provided by the D-Mark. The question is what effects the GEMU would have on the inflation rate and interest rate in Germany. As conversion between D-Mark and Ostmark mainly will take place on a 1:1 basis, this will certainly lead to inflationary pressures in the German economy, as well as pressure on the interest rates. One must also take into account the time it will take for an efficient reform of the GDR's economy and the perceived overheating of the FRG's economy (depending on the fiscal policy measures taken and on the possibility for collective wage bargaining), both factors pointing towards the possibility of a more lasting inflationary pressure. This would furthermore lead to an upward pressure on interest rates. These effects would upset some of the basic features behind the success of the EMS, i.e. the DM-anchor and its pursuit of disinflationary policy. This development has been feared by most of the ERM countries, and especially those like the Netherlands that are closely pegged to the DM, but also France whose disinflationary policy has been a success basically because of the central position of the D-Mark. The current uncertainty has resulted in the Dutch considering the separation of their currency from the DM [23]. The MU could here, in a certain sense, be seen as a solution in order to avoid the dissolution of the DM-bloc. MU could, moreover, be a way for the Germans to make others help bearing the costs of GEMU.

The general development in Eastern Europe has made most of the EC countries see the need for a stronger integration, both in order to secure the achievements so far - or "acquis communautaire" - and to show how successful a democratic integration process can be, and, thus, make it an example for the Eastern European countries [24].

There is, thus, the wish to strengthen the integration process to show that the EC is the strong and dynamic force in the shaping of the future "face" of Europe. In other words, there is a felt need to parallel the East's process of democratisation - but also of disintegration - with increased political/economic integration in the West, in order to create a strong nucleus in a changing Europe. Thus, the political will to move further towards a European Union

[23] See Financial Times, 15 February 1990.

[24] It is clear that the success of the process of integration in the EC was a motivating factor behind developments in Eastern Europe. One sample of the feeling Eastern Europeans have towards the development in the EC, was given by the Polish Solidarity leader, Bronislaw Geremek, who at a student meeting in Paris recently, said: "For us Europe is the continent of freedom. Europe was the inspiration for our dreams. A further acceleration of the process of European unification is necessary to secure democracy and the current progress, as well as to prevent nationalism and German hegemony" (Translated from Norwegian; Aftenposten, 1 March 1990).

has become more apparent and many see MU as a large step in that direction. This is evidenced by granting the European level the power over monetary policy - and more specifically, the money creation - which until now has been an essential and integral part of statehood.

I would sum up the motivating factors by quoting the Independent (25.2.90): "The stake is more political than economic".

5. Necessary and sufficient conditions for a MU

The motivations for creating an EMU seem to be quite clear and the "12 governments, in their bold European way, have already committed themselves to MU, even though one or two fine details still have to be decided. For instance: What does MU mean?..." (The Economist, 19.05.90).

In fact, the EC countries have not signed any document which clearly commits them to establishing a precisely defined MU. The SEA does not clearly define what an EMU or MU implies. The Madrid summit did not give any further clarification, in that only the first part of the Delors report was adopted, and that the rest of it would be considered a working document providing a good basis for further debate on necessary institutional changes in connection with an EMU [25].

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[25] See the treaties (EC, 1987) and the Delors report (EC, 1989).

Gros (1989) quite correctly states that the "kind" of MU you define will have an effect on the costs and benefits (both political and economic) yielded. And given the commitment to create a MU, the argument may be reversed, in that the costs and benefits of different aspects of a MU will determine the features of it. If certain features of a proposed MU are seen to have too negative effects on one country, this might be taken into account in the political bargaining process. First, therefore, it is necessary to make an a priori assessment of what the necessary and sufficient features of a MU must be, based primarily on economic theory. This will be the basis upon which the political economy cost-benefit analysis will be built. A small margin of alteration of this a priori definition must be permitted on the basis of the cost-benefit analysis.

Although authors on the subject differ widely as to what they perceive to be the necessary and sufficient conditions/features of a MU, there is a core common denominator: MU must combine irrevocably fixed exchange rates with full capital mobility.

There seem to be no doubt that the two basic features that make up a MU must be accompanied by a European monetary authority with the power to determine the monetary policy of the Union. With a single currency this statement is obvious, but the theory of Mundell and Flemming tells us that the more perfect the capital mobility combined with fixed exchange rates, the less efficient the use of monetary policy [26]. This idea is also pursued by Padoa-Schioppa (1983, op.cit.) when he points to the "inconsistent quartet", i.e. the incompatibility of free trade, full capital mobility, fixed exchange rates and national autonomy in the conduct of monetary policy coexisting simultaneously [27].

Peter Robson (1987) argues that if the above-mentioned necessary conditions for a monetary union [28] are to be adequately guaranteed, two further requirements would be needed: First, all power over monetary policy within the Community would have to be assigned to a central (European) monetary authority [29]. Second, The monetary authority would have to assume responsibility over the external exchange rate policy [30] and control the pool of exchange reserves. These, according to Robson, would be the necessary and sufficient conditions for a Monetary Union and, "effectively, there would then be a single currency" (p.137).

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[26] With an autonomous monetary policy, e.g. an attempt to increase the money supply, will only lead to a reduced interest rate which will be immediately offset by an outflow of domestic capital, leading to the reduction of the money supply and an increased interest rate.

[27] The reasoning follows the lines drawn by the Mundell-Flemming model, but for a comprehensive discussion see Padoa-Schioppa (1988, pp. 372-3).

[28] I.e. irrevocably fixed exchange rates and full capital mobility (through the abolition of all exchange controls).

[29] Robson states that "the immutability of fixed exchange rates would depend on mutually consistent monetary policies within the area".

[30] I.e. between the Community and third countries.

However, there are other features that need to be discussed: Is there a need for a de jure single currency (as opposed to the de facto single currency advocated by Robson)? And secondly, is there a need for harmonisation of fiscal policies? (There are also other questions that could be asked in this connection, like the organisation and degree of autonomy of the ECB. This is, however, not as relevant to the cost-benefit analysis, and is therefore omitted at present.)

As Robson pointed out, irrevocably fixed exchange rates and a single monetary authority would effectively create a single currency. However, the question of a de jure single currency is related to the perception of the actors in the financial markets. If they perceive the continued existence of national currencies within the EMU as a safeguard clause by which countries witnessing increasing national disparities in economic performance will recur to national monetary policy, then this in itself might lead to speculative flows creating strains on the system - thus a kind of self-fulfilling uncertainty.

Regarding the need to coordinate fiscal policies, there are good arguments both in favour and against this point [31]. However, political realities make it a highly hypothetical feature to add to the necessary and sufficient conditions of the MU. The different countries' reaction to it and the Commission's newly published blueprint for an EMU indicate that institutionalisation of such

[31] See the Delors-report (op.cit.), Thygesen (1989) and UK-Treasury (1989).

coordination is not on the political (or economic) agenda. The EC countries will not accept any curtailing of their power to conduct an autonomous fiscal policy - this is too much at the heart of statehood. However, the refusal to institutionalise binding rules on budget deficits does not mean that there will not be any constraints on the possibility to pursue discretionary fiscal policies. The Monetary Committee agrees on the following two rules: (1) No financing of the budgets by the central banks; and (2) no solidarity in favour of indebted countries by other states or by the Community. These rules - if adopted - will create effective strains on the possibility to overexpand government spending.

Thus, the a priori assessment of the necessary and sufficient conditions for the stable existence of a MU stresses the following features: Full capital mobility, irrevocably fixed exchange rates (and thus a de facto single currency) and an ECB with the responsibility for both external and internal monetary policy. In a longer-term perspective a MU will also need to have a - de jure - single currency. This assessment will form the basis for the cost-benefit analysis.

6. Cost-benefit analysis

The cost-benefit analysis has been divided in two parts: One general part, i.e. dealing with gains and losses that may be expected to influence the region as a whole; and a country-specific cost-benefit analysis. The general part will mainly deal with the economic aspects (due to the political aspects largely having been dealt with under the motivating factors), and will try to show that we are looking at a positive-sum game, the need for which is essential for the establishment of a MU [32].

The country-specific cost-benefit analysis is also important since it is not only the overall gain that matters, but also to a large extent the relative distribution of this gain between the member countries. The need for such an analysis is strengthened as decisions regarding EMU - implying institutional changes - will have to be taken at an Intergovernmental conference (IGC) [33]. Thus, theoretically, each country has a right of veto against the plans.

Loukas Tsoukalis (1989) points out that "any... policy regime ... entails costs and benefits which are not equally distributed among participants. There are winners and losers or, at least in positive sum game situations, some who gain more than others. The ...shift from situation A to situation B, should largely depend on the existing balance of power, both internal and external, and the actual or expected distribution of gains and losses"(p. 58). This, quite correctly, points to the fact that the analysis needs to take account of the existing balance of power within the current EMS.

[32] See the basic assumptions in the introduction.

[33] This is firmly stated in the SEA article 20, which refers to art. 236 in the Treaty of Rome.

6.1 General costs and benefits

Benefits

Economic theory focuses on the gains that accrue to the union from the irrevocable fixing of the exchange rates as opposed to fixed, but adjustable, rates. These gains stem mainly from two sources: Reduced transactions costs and reduced costs related to uncertainty about exchange rates.

Transactions costs are the costs of transacting from one currency into another. It is difficult to make an exact quantitative estimate of the importance of these costs. However, Walter Eltis (1989) recently published a paper which estimates the costs to amount to 0.5 - 1% (of the total value of the transactions) for commercial transactions, and 2.5 - 3% for tourist transactions [34]. (These costs are small in comparison to the costs related to exchange rate uncertainty [35].)

As long as there are exchange rate fluctuations, be it from realignments or from fluctuations within the allowed band, there will be uncertainty related to the international financial transactions. This has an impact on both trade transactions and on capital transactions. Although forward trade transactions are

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[34] Eltis further calculated that an EMU might mean a transaction cost saving of not more than 1 - 1.5% of GDP.

[35] For further comprehensive analyses of transactions costs, see Brittan & Artis (1989) and Swann (1988).

useful in hedging a large part of the uncertainty, there will be impacts on trade from the costs that accrue from the protection acquired through the use of the forward market. However, only about one tenth of capital transactions is related to trade, the rest are related to financial capital transactions. The Padoa-Schioppa report (1987, op.cit.) points to the fact that the removal of exchange rate uncertainty fosters the integration and rationalisation of economic activity. Where uncertainty exists - business require a higher rate of return on investments thus obstructing full (optimal) utilisation of the resources and especially the efficient use of capital. This point is difficult to highlight through empirical evidence since there are so many factors that enter into an investment decision. It has to be stressed, however, that the costs are higher than what a static analysis comparing a fixed but adjustable and irrevocably fixed ERS might suggest. The reason is that according to the discussion on p. 11, the alternative to a MU is not the current EMS, but a system with wider margins of fluctuation for the exchange rates - and, thus, increased uncertainty.

The aim of the internal market project is to obtain the so-called four freedoms - free movement of goods, services, capital and labour. The discussion above suggests that at least three of these freedoms will be hindered without an EMU, i.e. the free movement of goods, services and capital [36]. Accordingly, the lack of an

[36] The mobility of labour should a priori not be directly affected by the exchange rate regime. However, if an EMU would lead to harmonisation of fiscal policies throughout the Community then this might facilitate labour mobility. This is a highly hypothetical question, since labour mobility within the Community

MU could be an impediment to yielding the full benefits from the SEM project [37]. Although impossible to quantify the costs of not having an MU, it is easily deduced that these are of a larger magnitude than the costs related to transactions.

With an ECB responsible both for internal and external monetary policy [38] - with a well defined aim of keeping monetary stability - it is likely that the European currency will become a stable and highly regarded currency. It may, thus, become a widely used reserve currency with the benefits that implies in terms of seigniorage and the possibility of having lower interest rates without fear of capital flight. This will give the union an expansive input directly through the lower interest rates and indirectly through the possibility that seigniorage gives the union to finance a budget deficit. This is the situation for the dollar, where the US treasury is able to finance large public deficits without that seeming to affect the value of the dollar. A question is of course whether this deficit financing - and thus increasing debt - will prove healthy for the international monetary and financial system in the long term.

There is not much doubt that the credibility of the system would

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is and probably will remain limited. (See Social Europe; EC, 1988).

[37] For an extensive analysis and quantification of these benefits, see the Cecchini report (Cecchini 1988).

[38] "Internal" referring to the internal money supply and thus interest rate and inflation rate, while "external" monetary policy refers to the relation between the de facto single currency and non-EMU currencies.

be greatly enhanced through a de jure single currency, than a de facto single currency. This is due to the large probability that twelve different national currencies - although irrevocably linked - would be perceived by the market to be potential means by which the nation-state could fall back on national monetary policy. Having a de jure - and de facto - single European currency would also increase its attractiveness as a reserve currency.

If a common currency is established (whether de facto or de jure), it would possibly become a strong competitor to the dollar in the world portfolios, due to its increased supply (relative to the supply of D-Mark alone), its increased accessibility, and, possibly its increased stability through the predictability of the monetary policy pursued by the ECB (compared to the current situation of fixed but adjustable exchange rates). With increased competition between the USD and an "ECU" on the international financial market, the stability of the international monetary system might increase. In particular, Europe would benefit in that it would be able to use its own currency, rather than the USD as a reserve asset. The US would also benefit to the extent that a monetary system based on two currencies would make the external value less volatile (Bruges Group, 1989). Such a development would also make the Europeans a strong actor in the international monetary system, with the benefits that might be brought about by reducing the dependence on (a declining(?), or at least uncertain) US hegemonic power in the financial field.

With a de jure single currency, additional benefits would accrue from the reduced need for holding foreign reserves. First, because with a pooling of the reserves the need to hold the reserves would be reduced compared to a situation where each country has to hold foreign reserves. Second, there would be no need for foreign reserves in connection with intra-European trade (Robson, op.cit.).

Furthermore, reference is made to the effect on private agents in the price and wage-setting procedures. The certainty of no accommodating national policies will dissuade private agents in trying to seek wage and price increases. (This argument will be influenced by whether you have central/collective bargaining or rather local wage-bargaining systems.) (Padoa-Schioppa, 1987, op.cit.).

Costs

The most often cited cost related to EMU is the loss of sovereignty in monetary policy-making that an effective MU would entail [39]. National monetary autonomy is the ability to independently determine the rate of growth of the domestic money supply. Samuel Brittan (1989) characterised this sovereignty as the "right to inflate at a faster rate than Community partners" (p.17), reflecting the rather common view that monetary policy has little real effect, apart from the effect derived from divergent rates of

[39] The loss of sovereignty within EMU is mostly related to national monetary policy, and not to fiscal policy, since the principle of subsidiarity (see the latest report on EMU from the Commission) seems to suggest that no binding rules will be laid down for the conduct of national fiscal policy.

inflation internationally. For most countries this is not exactly what they are looking for when claiming the need for monetary sovereignty.

Furthermore, this raises the question of real versus nominal autonomy in the conduct of monetary policy. The EMS has been able to survive because the ERM countries have accommodated the monetary policy pursued by the Bundesbank. Thus, inherent in the current system has been the forsaking of national monetary policy in favour of the collective good which a stable exchange rate is seen as being [40]. Monetary policy within the EC has basically been aimed at keeping stable exchange rates in order not to destabilize the EMS system. Only the German authorities have had a certain possibility to pursue discretionary monetary policies. However, the Germans value monetary stability, and have, therefore, granted the Bundesbank close to full independence in the conduct of monetary policy. This leads to the conclusion that in real terms the autonomy in monetary matters is already strongly eroded.

Seigniorage is another aspect of monetary sovereignty - specially important for the southern European countries (i.e. Italy, Greece, Spain and Portugal). The revenues that accrue from seigniorage are far from negligible in countries with a relatively high rate of

[40] An example could be the unilateral German rise in interest rate October 5 1989, which almost immediately was followed by all the other EC countries (also the UK), in spite of the fact that most of these countries have higher both nominal and real interest rates (Financial Times, October 6 1989).

inflation [41]. With a single currency and a single European authority responsible for the issuance of money, the member-states would lose this income. This might create the need for a restructuring of the fiscal system - or increased rate of taxation - which again might create political problems domestically. However, an analysis by Cohen and Wyplosz (1988) finds that seigniorage is but a minor source of steady government revenue, and claims that the income from seigniorage would not be seriously reduced in a situation with one European currency as compared with the current situation. The question then becomes how to distribute this Community level income.

The theory of an optimum currency area (OCA) was first put forward by Mundell (1961). This theory sets out to find criteria by which one can characterise a currency area, i.e. an area with one common currency. Mundell pointed to the need for factor mobility in order to avoid unemployment and inflationary pressures building up in certain regions as a result of external shocks affecting the regions of the MU in different ways. Later studies have pointed to other criteria, like the degree of openness (McKinnon 1963), the degree of diversity in the economy (Kenen 1969), the degree of financial integration and homogeneity of inflation rates. This theory generally points to the fact that if the conditions that should make up a currency area are not fulfilled, there may be large costs for the union in the form of increasing regional

[41] Seigniorage today mainly accrues as a result of the states' possibility to print money since there is no interest rate on the holding of money, while there will normally be a positive real interest rate on government bonds etc.

disparities, as the regions no longer may recur to competitive devaluation. Some regions might be witnessing increased unemployment and some areas will see capital being drained away towards more productive areas. This is a development that contradicts the spirit of the Treaty of Rome, where it is firmly stated that the aim is to reduce the existing disparities [42]. A Danish ministerial report on EMU tries to evaluate whether the ERM countries could constitute an OCA. But, because of the character of the theory it is impossible to quantify the analysis and the report does not give any clear conclusion [43]. Thygesen (1987) arrives at the same conclusion. It becomes quite clear, however, that it is necessary for the plans for an MU to be accompanied by the increased potential for regional transfers through a strengthening of the EC budget and the structural/regional funds.

In sum, this general cost-benefit analysis seems to indicate that the plans for an MU must be regarded as a positive-sum game in economic terms. The general political arguments also suggest that the plans for an MU are viewed favourably, and that the strength of these arguments has augmented relative to the purely economic arguments.

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[42] In the preamble of the Treaty of Rome it was stated that the contracting parties were anxious to "strengthen the unity of their economies and to ensure their harmonious development by reducing the differences existing between the various regions and the backwardness of the less favoured regions" (EC Treaties 1987, p. 119).

[43] See the Danish Ministry of Economy, 1989.

6.2 Country-specific costs and benefits

In this analysis I will be looking at costs and benefits that are specific to each country, and how the plans for an MU are perceived in each country. This analysis will only look at the positions of Italy, France and Germany, which, in my opinion, are the major actors in determining the path of European monetary integration. The reason for not taking explicit account of the British position is the increasingly marginalised position they have set themselves in. This is mainly a result of Thatcher's repeatedly voiced opposition to increased integration [44] in Europe. Thus, in spite of the need for consensus in order for an IGC to ratify a change of the Treaty of Rome, I do not feel there is any great need for a thorough discussion on the British standpoint in this matter. It would be possible for the eleven to go further towards EMU by drawing up an additional EMU treaty instead of amending the original treaty [45]. Thus, effectively, creating a two-speed Europe.

Regarding the remaining eight EC countries, three - i.e. Greece, Portugal and Spain (only Spain is a member of the current EMS) -

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[44] This has surfaced both in relation with discussion on EMS/EMU, the social charter, rules concerning pollution, the EC (EPC) stand on sanctions towards South Africa, etc. etc.

[45] Although less encompassing, the almost agreed Schengen plan was a similar move showing the possibility for some countries to proceed faster than all of the member countries are willing or able to do.

with their relatively weak currencies will need a long period of transition before it will be possible for them to take fully part in an MU. However, they seem to endorse the political arguments in favour of further political and economic integration. The Benelux countries, Ireland and Denmark are in a somewhat different position. They have small, open economies which are highly dependent on stable exchange rates, in order to reduce the adverse effects of exchange rate volatility on their economies. In this connection they have accepted the economic argument advocating the need for a strengthening of the EMS. Furthermore, most of these countries are strongly supporting the political arguments in relation to an MU. It seems like all these countries have lined up behind the main actors and given them (and the UK) the centre stage in the debate on MU. This indicates a tacit acquiescence to the arguments presented.

Germany

There are two specific matters which must be underlined before it is possible to understand and analyse the position of the FRG (or maybe what is soon going to become a united Germany) with regard to further monetary integration in Europe.

Firstly, the Federal Republic of Germany has, with its strong currency, its relative economic weight within Europe (especially in industrial goods), and the success of its non-inflationary monetary policy, become the natural centre point of the current EMS system - a position they are very aware of. The FRG is de facto functioning as a hegemon in monetary matters. There will be no further monetary (or economic) integration in Europe unless Germany decides to move in such a direction.

Secondly, it is a matter of assessing the impact of German economic and monetary union (Gemu) on the future prospects for a monetary union in Europe. Some have advocated that the bold manoeuvre towards a rapid completion of a Gemu will divert German attention and interest away from the plans for a European MU (and EMU). Not only would political interest be diverted, but the D-Mark might also be seriously destabilised (i.e. leading to higher inflation and interest rates). However, the economic worries do not seem of major importance, compared with the political problems. West German experts, for instance, have come to question the attractiveness in Bonn of an ECB once the D-Mark has become the currency of a united Germany and is playing a growing role in Eastern Europe (The Economist, February 10 1990). However, both recent political statements and economic facts seem to contradict this point of view.

Chancellor Kohl recently voiced strong support for the idea of further European integration as a process of strengthening the "European roof" under which German reunification is to take place (Financial Times, April 2 1990). This emphasizes again the strongly felt European commitment in Germany, which a lot of people have come to doubt. A fact implicitly reflected in the claims for further integration with the aim of "tying Germany more firmly to" the other EC countries. It is, of course, questionable whether these statements are a sign of true Europeanism or rather more a reflection of domestic necessities [46]. Although there is ground to believe that there are also domestic considerations behind Kohl's position, the FT interview with the Chancellor arrives at the conclusion that he is a committed European. This impression has recently been strengthened by the recent call by President Francois Mitterand and Chancellor Kohl for an early move towards political union (FT, 20 April 1990).

This occidental commitment was further stressed in the Chancellor's reassurances that the whole of Germany must remain within NATO (FT, April 2 1990), which dissipates any fears of a German bid for neutrality, a move that would have destabilised the whole security system in Europe. However, it remains to be seen what the "two plus four" negotiations [47] will bring about in this field.

However, there is not only altruism and Europeanism indicating an apparently pro-MU stance in Germany. The commitment to substitute the worthless Ostmark with the strong D-Mark at a 1:1 rate might lead to an overstretch of the D-Mark. This will induce large costs on the FRG's economy - and thus create strains within the EMS. In an unpublished report by the Banque de France the costs of Gemu and

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[46] A parallel could be drawn to Chancellor Willy Brandt's support for the first plan for EMU in Europe. This was largely seen as a need clearly to express the FRG's commitment westwards as a counterweight to the recent focus on Brandt's "Ostpolitik" (Tsoukalis, 1989, op.cit.).

[47] Negotiations between the two Germanies and the four powers that occupied Berlin after the war, i.e. the USA, the USSR, France and Britain.

its implications for the EMS and MU have been assessed. It concludes by stating that the FRG, and the Bundesbank in particular, are today much more dependent on an MU in Europe than one is generally lead to assume. "An MU is the best way the Bundesbank has at its disposal to avoid a monetary creation that would compromise the credibility of the D-Mark". In an MU these costs would necessarily have to be carried by all members. Furthermore, the increasing - and massive - use of D-Mark throughout western Europe constitutes a threat to the German economy. The increasing demand for D-mark leads to a gradual appreciation of the currency compared to what real economic variables would lead to. This again threatens the whole EMS. An MU would "let Germany off the hook" by creating a de facto or de jure common currency that would function as a reserve currency, thus reducing the demand for one single country's currency.

In spite of the importance attached to the political dimension of the links with the EC and NATO countries and the economic interests it has in an MU, it is equally clear that Germany is not willing to sacrifice the achievements of the current monetary system in which the independence of the Bundesbank (the de facto European Central Bank [48]) has been a - if not the - central feature, unless the ECB - or "Eurofed" - is assured an equal degree of independence and primacy is given to the pursuit of a non-inflationary policy.

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[48] Expression used in the Financial Times, October 6 1989.

This fact and the relative importance of the FRG in the EMS - as outlined at the outset of this chapter - and the political importance fellow EC countries attach to the plans for EMU, indicates that German demands regarding the organisation of the European Central Bank and its mandate to a large extent will be met.

In this context it becomes interesting to analyse the content of the conflict (if any?) between the Bundesbank and the West German government. Although agreeing to the need for an MU in Europe [49], the President of the Bundesbank, Mr. Karl Otto Pohl, was initially sceptical about forcing the pace towards MU [50]. Today, things have changed somewhat. The fear of overstretch of the D-Mark through Gemu and the obvious reduction in the Bundesbank's independence as a result of the process of German reunification have lead Mr. Pohl to recognise the need for an MU in Europe within a rather short timetable. He has presented an uncompromising vision of a strong and independent ECB. The main ingredients of this vision is independence of political interference and monopoly of money creation in the EC - in other words a "Euro-Bundesbank". Pohl claimed that the ECB must above all be politically independent of governments, the European Council and the EC Commission "to

[49] After all he was one of the 12 central bank governors who participated in the drafting of the Delors report - and who signed it afterwards.

[50] In a speech held in Paris in January he warned that "a great deal could go wrong if a single currency and central monetary institutions were imposed too soon as part of an activist initiative to force the pace towards monetary union". (Financial Times, January 17 1990).

resist the ever-recurring wishes of politicians to prescribe monetary policy targets which are often inconsistent with the objective of stability" (tell the Italians!). This need, he said, applies particularly to the EC because "in a confederation such as the EC there is always a tendency to orientate oneself towards averages and compromises, but that is the worst possible compass for monetary policy" (FT, January 17 1990). According to Mr. Pohl the monetary policy to be pursued by the ECB should be aimed at battling inflation due to the importance attached to monetary stability.

On the other hand, there is Mr. Kohl who until recently had not pronounced himself on these more specific matters. In the FT interview (op.cit.) he outlines the following principles as fundamental for a future ECB:

* priority to monetary stability
* total independence from government
* sovereignty over monetary policy questions
* an obligation towards convergence of economic, particularly budgetary policies among member states.

These visions are in no way conflicting with those of Mr. Pohl [51]. The above analysis, thus, seems to indicate that there is, firstly, a strong commitment in Germany to the pursuit of the plans

[51] This also goes for the last point on convergence of budgetary policies. The Delors report advocates the need for "binding rules" on maximum budgetary deficit - a feature that was added at the insistence of the president of the Bundesbank. The logical explanation for this claim - however controversial - is found in an article by Thygesen (1989).

towards MU, and secondly that the speed at which the plans will come about will depend on to what extent the German conditions regarding the organisation of the ECB and its policy priorities are met. The Germans will probably have to accept that their terms regarding the establishment of an MU possibly will not be fully met as it is perceived that they are not only going along the MU path out of pure European altruism.

France

The French people seem to be the most deeply committed (alongside the Italians) to the political process of European integration and a strong proponent for the idea of a EU. Pierre Jacquet [52] stresses that all the time since the Werner report in the early 70s, France has supported European MU as a way to promote both economic and political cooperation. Today, more than ever, MU is the point of focus for French policy makers. Jacquet sees the stake as being rather more political than economic because of the current situation pointing to an MU dominated de facto by the D-Mark (The Independent, February 25 1990). Another reason why the stake could be said to be more political than economic relates to the current French obsession on tying Germany closer to the EC. From relying on the German-French partnership to promote Europe, France's strategy has shifted towards using its European policy to provide a positive "containment" of the future Germany, i.e. a framework in which German economic power is harnessed to further the

[52] Associate director of the French Institute of International Relations.

prosperity of the EC. Surprisingly, at a time when the Franco-German axis seemed to be strongly weakened, it seems to have been patched up again through the recent joint initiative for an early move towards a political union in Europe. French fear and German need to prove their "Europeanism" appear to be the reasons.

France has through its participation in the EMS acquired the lowest rate of inflation the country has seen for decades. This "acquis" is something they would not like to see wasted. Combined with the French wish to have a more symmetric monetary system in Europe, this explains the French support for an independent ECB with priority given to price stability in the conduct of monetary policy. Continuing on the argument for symmetry, the French would not accept the D-Mark as a common European currency, but would rather see the ECU - or a similar device - taking such a position [53].

However, it appears that the political argument related to the "containment" of Germany has the upper hand on the argument relating to the lack of symmetry. The speed at which German reunification is taking place has prompted the French (and the Italians) to press for the IGC being brought forwards [54]. This eagerness to bring forward the signing of an EMU accord indicates a willingness to compromise on certain aspects as long as such an

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[53] See article by Jacques de Larosière, Governor of the French Central Bank, in Il Sole-24 Ore, 31.03.90.

[54] To July instead of December 1990, Financial Times February 15 1990.

agreement is reached in a shortest possible time. However, the report from the Banque de France (op.cit.) clearly recognises that German reunification offers them the possibility to take "an offensive position ... in the construction of the EMU".

Lastly, there is a strong consensus across party-political lines and throughout the French society on the need for further steps towards European unification.

Italy

Italy is possibly the country where the commitment towards a European federation is strongest - at least in words [55]. The whole political spectrum in Italy favours the idea of a federal Europe, and sees MU as a way of getting there [56]. It is important to be aware, moreover, that the support for the integration process is deeply rooted in the population. A popular consultation on the issue of a European Union resulted in a 90% majority declaring itself in favour of a move towards a supranational EU. This points to the fact that the whole debate around MU has been highly politicised in Italy (as opposed to economised) and that the economic costs and benefits have been given relatively less weight compared to the political arguments relating to the MU as a step towards EU.

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[55] The Italian performance, in terms of implementation of directives adopted by the Council of Ministers, is among the poorest among the member states (FT, 25 Sept. 1989).

[56] See The Economist, 17.02.90.

This argument has become even stronger with the developments in Eastern Europe. The prospects of German reunification has prompted many Italians to favour a speeding up of the process of integration. The reason for this may be said to be twofold: First, the fear of a dominant Germany turning inwards instead of acting as a centreforce within the EC. Second, there is the fear that the process of German reunification - and especially its first step, Gemu - might upset the D-Mark anchor of the current EMS. The consequences of such a development have already been discussed. An EMU with an independent central bank, and a single currency, might be even less subject to one country's domestic policy priorities. That the question of reunification has strengthened the push for MU became clear after Italy and France jointly decided to try to push for the IGC being held earlier. They failed in this attempt and the date, mid-December 1990, is maintained.

Furthermore, the Italians hope that an ECB would restore some of the monetary sovereignty that their membership of the EMS has shifted to the Bundesbank. They want an MU to deliver West German levels of inflation without German hegemony in monetary affairs, thus a parallel position to that of the French. This might be achieved through the establishment of an independent ECB. This is why there is a rather strong Italian support for the view of the Bundesbank's president, of the new banks' accountability being limited to its president reporting to the European Parliament [57].

[57] See the Economist, op.cit.

The Italian Treasury, with its Minister, Mr. Guido Carli, has been criticising the Bundesbank's pursuit of disinflation as the sole focus of its policy, and has advocated the need for employment and growth also to be taken into account in the monetary policy. They see an ECB as the only means by which such a change in monetary policy could come about, since the Bundesbank's performance - and the German economy's performance more generally - does not give the Bundesbank any incentives to change its policy priorities. However, taking into consideration Germany's strong bargaining position, and the Italians' objective need for a lower rate of inflation, it is unlikely that they will oppose the creation of an independent ECB with price stability as its prime objective.

Furthermore, the Bank of Italy and the Treasury seem to favour the idea of MU on the merit of the external constraints this will put on public spending. This is closely related to Italy's high public deficit - expected to be around $102 bn for 1990 (10.4% of GDP) [58] - which is mainly due to the parliamentary situation and the right single members of Parliament have to propose spending legislation. The sheer size of the Italian public debt is, however, used as an argument against an early introduction of an MU. In the future this will require a greater part of the public spending being used to service the debt. With reduced income from seigniorage, this might induce a strong need for fiscal

[58] See the Economist, 16.12.1989.

restructuring and increased level of taxation.

Nevertheless, recent months have shown that the attention given to the economic aspects of MU (and EMU) has decreased relative to the political importance attached to it. This reflects generally the implicit understanding in Italy of the MU as a positive-sum game, also in economic terms.

7. **Conclusion**

The general political economy cost-benefit analysis showed that plans for an MU in Europe may be considered as a positive-sum game. However, the discussion around the costs related to the theory of OCA indicates that the costs in the longer term will be greater if the monetary union is not accompanied by sufficient economic integration, i.e. capital mobility, labour mobility and convergence in inflation rates etc. This suggests that it would be unwise to move too quickly towards a full MU, and that at any rate it should not precede the completion of the SEM.

However, the recent debate suggests - and the country analysis above supports this view - that the EC countries (with the possible exception of the UK) will make a bold move towards an EMU in Europe. In spite of differing motivations, they all seem to have an interest in an early move towards MU in Europe. This was confirmed at the Dublin Summit (28/29 April), where there seemed to be a large majority among the EC finance ministers in favour of establishing an MU by 1.1.1993 - at the same time as the SEM is supposed to be completed. This reflects the perception that any costs that might be yielded by a forced pace in the monetary integration process, will be outweighed by the positive political benefits that such a move will bring about. Apparently the political and short-term economic arguments from an MU seem to have overshadowed the longer-term economic effects. The above analysis suggests that the political conditions in Europe are favourable to the establishment of an MU, something which was not the case at the time of the earlier attempts.

Regarding the features of an MU, the assessment of the main actors' position and the weight they carry, seems to suggest that an ECB will be established, and that this institution will be granted a large degree of autonomy. A sine qua non condition for the establishment of an ECB is that it be given as primary objective the pursuit of a disinflationary policy. There is little controversy on this point, and the Bundesbank and the German authorities will not compromise on this point. It also is implicit in this analysis, that both the Italians and the French will push for an ECB with a federalist structure, insuring them a say in the monetary policy to be pursued. Furthermore, it seems likely that after a certain transitional period the EC countries will move towards the introduction of a single European currency. This would be a useful move in the process of political unification of Europe, as well as increasing the credibility of the monetary unification process - a credibility which the success of the process is fundamentally dependent on.

Finally, there is an increasing recognition of the need for an MU to be accompanied by a political union. It should by no means be warranted to transfer power over monetary policy to the European level, without at the same time assuring a true democratic control at this level. Thus we see how important - both theoretically and practically - an MU is for the achievement of a politically more unified Europe.

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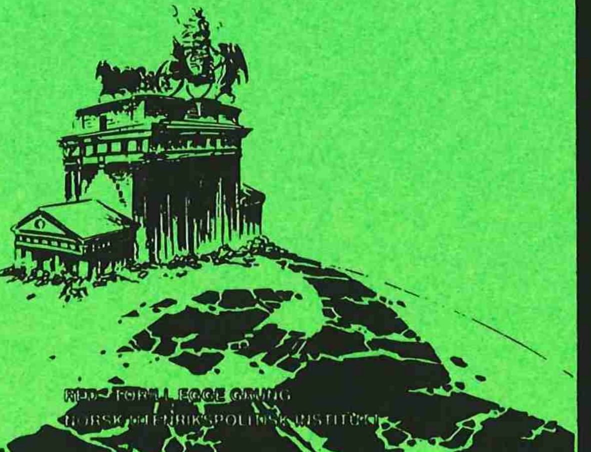

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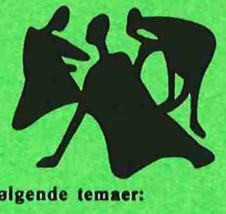

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