MONETARY INTEGRATION IN EUROPE 1992

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by

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When the member states of the European Community (EC)* passed the Single European Act in 1987, they thereby indicated that all these nations would form a united economic order by 1992. This EC action and subsequent steps also will move the member states toward greater political integration. A few advocates of this process of consolidation even anticipate that the changes planned for 1992 will take the EC close to true political union. This goal of a united Europe was envisioned by the leaders who laid the EC's foundations with the establishment of the European Coal and Steel Community in 1952 and the "Common Market" in 1957. As a dream among Europeans, the idea of unity that underlies these actions of the past thirty-five years emerged virtually at the birth of European civilization in the 300s A.D.

Many skeptics think that the vision of "EC 92" has no chance of realization. Europe 1992 has often been thought of by businessmen, politicians, and the general public worldwide as a project that would never get off its feet and, even if it did, a project that would never come to complete fruition. In fact, these antagonists had history on their side to back these claims. Ever since the passing of the reign of the Roman Caesars, the dream of a united and powerful Europe has met with failure,

* The member states of the EC include Britain, Germany, Italy, France, Belgium, Denmark, Greece, Ireland, Luxembourg, Portugal, Spain, and the Netherlands.

victim of the fierce independence that has permeated the various countries which shared geographical borders, but little else. Even the late President of France, Charles de Gaulle, warned of the impossibility of effectively governing a country that has "over 385 different types of cheese" (Silva and Sjogren 101). Contrary to the view of critics and the implication of history, the current program for unification of the member countries of the European Community into a single market is now well under way. Europe 1992 is about halfway through its implementation. The European Commission, an EC executive body, has formulated almost ninety percent of the 300 legal measures necessary to abolish fiscal, physical, and technical barriers to trade in goods and services (Walter 18). Perhaps the reason for the success of the plan so far results from the fact that this attempt does not come from the "heart or mind of a single person, party, or philosophy. Instead, its roots run deep in populist sentiment" (Silva and Sjogren 102). Additionally, this attempt for unification does not aim for world dominance as past attempts have. Rather, in keeping with the spirit of the Common Market at its founding, Europe 1992 is a quest for global equity.

Although failure is highly unlikely at this stage, the inability to achieve this single market would cost Europeans millions in unnecessary expenses and lost opportunities. Instead of this outcome, the forces behind Europe 1992 seem destined to transform the world of international business and bring changes that will far surpass even those generated by the Japanese rise to economic dominance (Silva and Sjogren 101). EC 92 will give a permanent boost to the prosperity of the people of Europe and the entire world. It will especially benefit the United States. More specifically, the new economic order will create immense opportunities within Europe for growth, employment, constructive competition, improved productivity, business mobility, stable prices, and consumer choice. "No single member state on its own could ever generate such a total transformation of its economic performance and prospects. It is only by completing the single European market of over 320 million people that will make those prospects a reality" (Cecchini xiv). Although such a successful restructuring is likely, many issues still need to be resolved before the program can be completed. Furthermore, certain measures will have to be carried out after the 1992 deadline. One of the most prominent issues facing EC members is European monetary integration. It is critical in that "the full benefits of the single European financial market will not be achieved unless there is a common European currency designed to preempt recurrent exchange rate fluctuations and a possible relapse into exchange rate controls" (Walter 22). When this goal of monetary union is attained, the EC will become the largest financial market in the world.

Over the past five years Europeans and others interested in EC 92 have actively debated the idea of monetary unification. Many proposals have emerged from this process of planning and discussion. An understanding of these competing notions of how and when to take this step is necessary before the most logical, efficient, and beneficial alternative can be chosen. In the subsequent pages, this thesis will review the choices and advance arguments for the most viable option.

One of the most detailed and logically impressive proposals was released in April 1989 by the Committee for the Study of Economic and Monetary Union, the Delors Committee (Thygesen 639). This proposal from the Committee chaired by the president of the European Commission is often used as the model for other monetary union plans. The Delors report stresses that two basic elements are necessary before monetary union can be fully achieved: completely free capital movement and irrevocably fixed exchange rates.

The Delors report proposes a three-stage approach to a monetary union that has these two traits. The first stage would aim at closer policy coordination on a voluntary basis (Thygesen 642). Additionally, all EC currencies still freely floating would be brought into the current European Monetary System (EMS)* exchange rate mechanism. Stage two would be a "soft" monetary union with the formation of a central bank being the most important task. This phase would be primarily a transition period further promoting convergence and centering on institutional reforms. The final stage could be described as "hard" union. Monetary union then would involve the move to

* The EMS is a system which keeps the participating currencies within certain defined upper and lower limits which results in exchange rate stability (Ungerer 14-15).

irrevocably locked exchange rates, strengthened common structural and regional policies, the introduction of a common currency, and the beginning of free-scale operation of the central bank or European System of Central Banks (ESCB). With respect to the latter measure, the report states that the ESCB should be independent of political institutions, committed to price stability, and organized on a federal basis in accordance with the political diversity of the EC (Walter 22).

The advantages to this proposal are many. For example, it is widely accepted that a complete single market cannot exist without monetary union and that monetary union "must imply the establishment, sooner or later, of a European federal bank with the power to issue European money" (Lodge 105). This establishment of the ESCB is a central point of the Delors Report.

The gradual approach is also a positive aspect of the report. For example, stage two is a necessary transition period to the final stage of locked exchange rates as it is hard to envision moving straight to fixed exchange rates without some experimentation. Stage two is also to be used for gradual narrowing of margins of fluctuation within the EMS (Thygesen 644).

Another advantage is that most of the member states are prepared to accept monetary union achieved by steps on the order of those outlined in the Delors Report. More specifically, Germany, the decisive country, accepts the report for two main reasons. The German leaders see price stability as a major objective, and they advocate this goal. Also, the report gives assurance of the autonomy of the central banking system, another feature preferred by Germany (Thygesen 647).

Surprisingly, France has responded in a positive way to the report. "Once upon a time, any French-man who advocated abandoning the franc might have been tossed off the Eiffel Tower, but attitudes are changing" (Day 30). In fact, there was even disappointment in France that the time-scheme of the report was not more radical. Monetary union would bring French interest rates down to German levels, and it would keep France from having to raise interest rates defensively as that nation has had to do in the past (Thygesen 647).

Italy has many attitudes in common with France. However, Italy is facing a budget deficit of ten to eleven percent of their Gross National Product (GNP). Thus, economic and monetary integration would allow Italy to avoid financing part of the deficit through money creation or surprise inflation.

Spain has reacted positively to the report. This country showed its support most concretely by its recent entry into joining the EMS, climaxing four years of growing Spanish confidence in the Community. Britain's transition in attitudes has paralleled Spain's. Once persistent in resisting both participation in the EMS and active moves towards economic and monetary union, Britain joined the EMS in October 1990 and is showing a willingness to accept some form of the Delors Report

(Ungerer 15).

Certainly, another advantage is that initial steps resembling those outlined in the Delors Report have already begun. On July 1, 1990, stage one of a process leading toward monetary union, as envisioned by the report, began. The European Council, a permanent European assembly established in 1948, has also drafted statutes for the ESCB. Council members, with the exception of Great Britain, agreed to begin stage two on January 1, 1994 (Ungerer 16-17).

Although it seems as though the Delors Report is the proposal which has been adopted, there are some disadvantages. Fortunately, it is not too late to allow for discussion of alternative roads to monetary union. Even the report itself allows for adjustments. For example, it gave no deadline for implementation of the proposed stages making the report a solid base but one in which a time-table to implement is wide open. More importantly, the report did not specifically mention that there will be a single currency within the EC, but alluded that this would be for the better.

Because of the problems in the Delors report, another proposal has been made that follows a similar pattern but specifically calls for monetary integration with a single currency. A single currency would replace domestic currencies whereas a common currency would be used throughout Europe alongside domestic currencies (Britton and Mayes 948). The most logical approach to the establishment of a single currency would be the development of the European Currency Unit (ECU), an existing "cocktail" of EC currencies and the basis of the EMS, into the single currency ("Kick" 81). The main disadvantage in the use of such a single currency would be the initial cost of changeover. This process would involve recalculating the value of millions of existing contracts into ECU terms. It would also involve calling in and reissuing all existing notes and coins in circulation (Britton and Mayes 948).

The advantages of a single currency are many. A single currency would eliminate all those transaction costs which are involved in switching from one currency to another even if exchange rates are fixed (Britton and Mayes 948). It would also significantly reduce the foreign exchange reserves currently held since reserves will not be needed for a variety of currencies (Gros and Thygesen 926). A single currency would erase the burden of making calculations whenever there are business transactions done across national boundaries and the inconvenience of keeping accounts in several currencies. It would discourage the incentive to hedge against the possibility of exchange rate changes, which occur without a single currency however "irrevocable" exchange rates are supposed to be (Britton and Mayes 948). A single currency would somewhat replace the U.S. dollar as a transaction medium and store of value. It could also be expected to greatly enhance competition throughout the EC financial arena (Gros and Thygesen 927) and give the private sector greater confidence that monetary union will be maintained

(Britton and Mayes 948). Finally, it is simply hard to believe that the monetary union could acquire true common identity and legitimacy in the eyes of the outside world without a single currency (Thygesen 639).

In response to this alternative proposal, there has been much debate about the use of the ECU as the single European currency. Two significant issues have emerged: (1) whether to use the ECU or some other currency (most likely the German Deutschmark); and (2), if the ECU is the most acceptable currency, whether or not to announce outright that it will be the single currency.

With regard to the first debate, using the Deutschmark (DM) as the single currency might be advantageous to commercial banks and other financial institutions in Germany. However, it is unlikely that the central bank of Germany, the Bundesbank, would accept such an outcome. It is also doubtful that the DM would become the single currency of Europe because of the obvious political objections it would create (Britton and Mayes 949). Thus, it seems that the ECU would be the most acceptable single currency. It is a currency basket of EC countries and therefore would escape much of the political opposition. Using this form of currency, central banks could set objectives for the ECU interest rate or the ECU price level, which they would work together to achieve (Britton and Mayes 951).

Another debate that has erupted is whether or not to announce immediately that the ECU will eventually be the single

European currency. For both political and economic reasons, it seems that immediate announcement would be the most beneficial. The announcement will let everyone know that all national currencies will disappear in due course. It would give European banks an incentive to develop business in ECUs as it would give them a competitive advantage during the transition period (Britton and Mayes 949-950). This increased business use would also help the ECU achieve status as a competitive commodity, establishing itself as a rival to the dollar and the yen and preparing it for the transition into the single European currency (Silva and Sjogren 142). Ultimately, the early announcement of a commitment to the ECU as the single currency could, "of itself, act as a catalyst and speed up the process [of monetary union]" (Britton and Mayes 950).

There are also other alternatives which do not follow the approach to monetary union set forth by the Delors Report. One such proposal has arisen because of concern that the freeing of capital markets and the formation of a single market will make the present European Monetary System unstable. Therefore, proponents of this alternative suggest allowing more flexibility of exchange rates during an initial period. This might be an attractive way of managing the existing EMS, but it is a step in the wrong direction on the way towards monetary union. "It would make the commitment to price stability weaker in those countries which allowed their currencies to depreciate" (Britton and Mayes 954), and it would delay the entire process of monetary union.

Consequently, this approach would stall the entire process of becoming a truly single market.

Another alternative is one which embraces the idea of currency competition. This alternative was presented by United Kingdom authorities in response to the Delors Report. Their concept of monetary integration advocates an evolutionary approach as opposed to the institutional approach set forth by the Delors Report (Ungerer 15). This approach would rely on "free mobility of capital and the natural forces of competition to create a spontaneous movement towards a common, or even a single, currency" (Britton and Mayes 954). Currency competition is a system which is both inadequate and infeasible. First and foremost, the most likely result of this approach would be more widespread use of existing currencies, especially the DM, the French franc, and the British pound sterling. It is unlikely that the ECU could prevail in such a competition (Britton and Mayes 955). "Currency competition would not in the long run provide more guarantees for price stability than the kind of joint management through a European central banking system which has been proposed in the (Delors) Report" (Thygesen 651). In currency competition, where national currencies are not irrevocably linked to each other, it is not possible to speak of monetary union or expect the full benefits which would come from monetary union (Ungerer 15). Furthermore, it is not entirely clear whether this proposal was framed with monetary union as its expected end result.

In June 1990, British Chancellor of the Exchequer John Major presented another proposal. It envisioned an important role for the ECU by having it exist and compete alongside national currencies. First, ECUs would be issued on demand against the other currencies. Second, the ECU would become a genuine currency that would never devalue against other EC currencies. Eventually, the ECU would become more widely used and could become a common currency and, in the very long run, the single currency of Europe (Ungerer 15). This approach seems feasible and acceptable on the surface, yet there are a few significant deficiencies which make it an unacceptable alternative. First, the proposal is vague in stating whether the ECU would eventually become the single currency or even the common currency. Furthermore, this alternative provides little guidance for a definite timetable for engaging in these ECU activities. Finally, it does not indicate "when the conditions would be right for moving to the final stage of full monetary union" (Ungerer 15).

Still another alternative is one which calls for forcing the pace of change. This alternative accepts fully the concept of moving towards a single currency. However, realizing that the gains from a single currency arise after the period of transition is complete, advocates of this alternative propose moving straight to adopting a single currency as soon as the administrative changes can be made. Unfortunately, simulation studies have shown that forcing the pace of change is too risky an alternative as it would not be manageable in economic or political terms (Britton and Mayes 955). Additionally, all of the EC countries are not prepared at this point to take on the costs of convergence into a single currency.

After examination of these many alternatives, an adequate, efficient, and logical process towards European Monetary Union may be put together. Because a first stage resembling stage one of the Delors Report began on July 1, 1990, and because of the many logical aspects of the report, the process towards monetary union should be formed in a framework resembling the Delors Report but containing some more specific directives.

First, the process should stress commitment to eventually initiating a single currency, the ECU, for the EC. This approach is necessary since it is well known that the single European financial market cannot be fully achieved without a common currency and probably without a single currency. With respect to the use of the ECU, it is important to announce at the outset that the ECU is going to be the single currency of Europe one day. Familiarizing the market with use of the ECU in the period of transition to EMU and discouraging the use of other national currencies is also a necessary procedure to be undertaken in conjunction with the ECU currency approach. Adhering to a process based somewhat on the Delors Report is also encouraged because of its gradual approach to monetary union. A forced or hasty transition to monetary union is simply not feasible. However, unlike the plan of the Delors Report, the process towards monetary integration should be set up under a specific timetable and should be implemented as closely as possible to this timetable.

It seems reasonable and widely accepted that the final step of this process would be taken in about 1997. At that point, monetary union would be formed, and, at the same time, the ECU would be introduced as the single currency of Europe. All other domestic currencies and all contracts made in domestic currencies would be converted to the ECU. From then on, "there would be an ECU money supply, and each member country would have an ECU-denominated monetary base--all firmly under the control of the new [central] banking system" (Britton and Mayes 957).

The achievement of full monetary union should be the last step in reaching the Single European Market, for it is widely accepted that complete unification requires common currency. Although other major problems do exist, success in reaching monetary union is much more complex and requires much more contention and arduous work than is necessary to overcome any of the other obstacles. For example, one of the other problems is the slow movement of the British in many matters. However, many agree that in most matters, at this stage, if advantages outweigh the disadvantages, it will happen with or without the British (Day 30). In most cases, it will be the British who would inevitably suffer a competitive disadvantage (Matthewson A19). Therefore, with such knowledge available, problems such as these can be overcome with a little work and some patience.

In the end, "Europe 1992," even if it comes in 1997, will produce the largest single financial market in the world, providing innumerable opportunities and benefits, many probably unanticipated, to the member states of the EC. It will similarly affect the United States and the rest of the world. However, EC 92 cannot promise any clear individual winners or losers as it brings about this single market. The winners will be determined by the extent to which companies and governments take advantage of these immense opportunities.

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