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# The Further Development of the European Monetary System

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## I. Introduction

The member countries of the European Community have made considerable progress in recent years in their efforts to achieve greater convergence in their economic policies and economic development. Stability of the value of money as the prime objective at the national level and exchange rate stability as the common goal within the European Monetary System (EMS) have been achieved to a higher degree than ever before. The generally favourable economic and monetary situation provides sound prerequisites for achieving the objective of creating a single European market by 1992. This would fulfil essential preconditions for an <u>economic union</u>.

With the planned creation of an integrated financial market with the free movement of capital, a basic component of a future <u>monetary union</u> would also exist. An additional basic element, namely fixed exchange rates, is admittedly not in prospect within the foreseeable future because setbacks in coordinating economic policy can no more be excluded than can disturbances in the financial markets and the real economy, which can make exchange rate adjustments necessary. Corrections in exchange rates will remain a necessary safety valve for the foreseeable future also within the EMS in order to reduce any tensions that may arise without incurring excessive damage to individual economies or the Community as a whole. Even the unification of the markets of Europe to form a single European market does not necessarily presuppose the existence of a monetary union or a common currency.

The time may nevertheless have come to develop some concrete ideas about the future process of integration which can lead to a monetary union. This is all the more necessary in that demands have increasingly been made in recent times to correct the allegedly uneven distribution of the burdens of adjustment and financing within the EMS in favour of the weaker partners, whereby the exchange rate mechanism is supposed to serve as a lever for bringing about common (average) objectives.

A number of the latest proposals seek to anticipate the emergence of new conflicts between the common objective of exchange rate stability and national notions of price stability through a quantum leap, by coupling the commitment to achieve a single European market and an integrated financial space with freedom of capital movements by 1992 with the creation of a European central bank. From the German point of view it is essential to ensure, in the discussions about the future design of a European monetary order, that monetary and credit policy is not geared to
1) stability to a lesser extent in an economically united Europe than is the case at present in Germany. Apart from this, the fact needs to be made clear that monetary integration cannot move ahead of general economic
2) integration, since otherwise the whole process of integration would be burdened with considerable economic and social tensions. Moreover, examples from history demonstrate that new nations did not confer a uniform monetary order on themselves until the process of unification was concluded. Any attempt durably to fix exchange rates within the Community and finally to replace national currencies by a European currency would be doomed to failure so long as a minimum of policy-shaping and decision-making in the field of
3) economic and fiscal policy does not take place at Community level. If this prerequisite is not met, a common European monetary policy cannot ensure monetary stability on its own. Above all, it cannot paper over the problems in the Community

arising from differing economic and fiscal policies.

The following thoughts begin with the basic elements of an economic and monetary union (EMU). However, the thread cannot simply be picked up at the ideas contained in the Werner Report as long ago as 1970, namely to move towards this goal via a multi-stage plan. With the "snake" and the EMS, experience has been gained and with the progress in economic and monetary policy cooperation facts have been created which suggest the need for a new start. In this context, it must be ensured from the outset that agreement exists between the Governments and the Community institutions for which they are responsible with respect to the basic issues of economic policy. Above all, agreement must exist that stability of the value of money is the indispensable prerequisite for the achievement of other goals. Particular importance will therefore attach to the principles on which a European monetary order should be based.

Drawing partially on preliminary work conducted within the Community on the second stage of the EMS, three models of monetary integration are then presented and examined with respect to their compatibility with the demands of a future monetary union. The models that have been selected take ideas into account that play a role in political discussions or could play a role in them at any time. Since it can be assumed that the goal of monetary union cannot be reached in a quantum jump but only as the result of process of integration encompassing economic and monetary policy, individual conceivable stages of integration with their political implications are taken into consideration. The problems are also discussed that arise from the differing speed of integration on the part of individual countries as well as from the institutional and legal aspects of integration.

# II. The final objective of monetary integration

## A. Economic and monetary integration

### 1. The characteristics of a monetary union

The final objective of monetary union was defined as long ago as 1970 in the Werner Report in a formulation that still applies today: "A monetary union implies inside its boundaries the total and irreversible convertibility of currencies, the elimination of margins of fluctuation in exchange rates, the irrevocable fixing of parity rates and the complete liberation of movements of capital." The decisive criteria for a monetary union are thus the irrevocable fixing of exchange rates and movements of capital within the single monetary area that are free from restrictions.

The monetary union is the "monetary superstructure" of the economic union in which the "four freedoms" have been realised, namely the free movements of goods, services, labour, and capital. Within the common single market, economic activity is to be based on a free market system of competition. Besides agreement on regulative policy, an economic union demands a far-reaching harmonisation of government regulations in order to bring about equal competitive conditions and uniform markets. Although structural and regional differences between the member countries (especially differences in income and productivity) are compatible with an economic union, the structural and regional policy of the Community must take them into account.

In principle, national currencies can be retained in the monetary union. However, the introduction of a uniform monetary symbol alongside individual national currencies would give the monetary union a "monetary identity", eliminate or reduce the residual risk of parity changes among the national currencies and hence create a symbol for the continuing existence of a single monetary area. The definitive replacement of national currencies by a common currency would be the "crowning act" of the process of monetary integration.

Above and beyond the effect a single European market would have in terms of integration, a monetary union provides a number of economic advantages. Firstly, the irrevocable fixing of parity rates means that the ex- 1) change rate risk associated with the intra-Community exchange of goods, services and capital is eliminated. This will foster in particular the integration of the 2) financial markets and the strengthening of competition. Secondly, there will be a saving in transaction costs since market participants will be increasingly willing to accept partner currencies or the common currency without taking recourse to hedging operations and to hold them as a means of payment or investment in the place of national currencies. Thirdly, through the creation of a monetary area with a greater weight internationally advantages arise in transactions with third countries 3) since the international acceptance of the Community currencies will grow, the Community will become less susceptible to external shocks and it will be able to represent its monetary policy interests more effectively at the international level. The introduction of a common currency is the prerequisite for taking full advantage of these benefits.

2. Implications for economic policy

Within the monetary union, economic policy must be directed towards eliminating causes of tension that could jeopardise its cohesion and towards preventing new tensions from arising. The irrevocable fixing of parity rates is possible only on the basis of exchange rates at which differences in rates of price increase, balance of payments positions and in the field of public finances have been eliminated to a large extent. With fixed exchange rates, insufficient convergence in these three fields would give rise to adjustment constraints in the real economy that would endanger the cohesion of the monetary union or would ultimately bring about adjustments in parities forcefully. The harmonisation of rates of inflation is necessary since any shifts that may arise in terms of price competitiveness can no longer be offset by realignments. Countries with an above-average rate of inflation would suffer competitive losses; conversely, tendencies towards excess demand would be triggered in countries with cost advantages.

No!

When parity relationships are irrevocably fixed, the external positions of the partner countries must be compatible with each other since competitive weaknesses of one partner would burden the aggregate balance of payments position of the monetary union vis-à-vis the rest of the world. Even if the current account position of the monetary union were in balance as a whole it would not be possible for a single country within the Community to incur debts indefinitely. Finally, there would have to be a large degree of convergence in the field of public finance. Considerable, or even unlimited, recourse by a member state (or the central authority)

a regional problem

to central bank credit would make monetary control throughout the monetary area difficult, if not impossible, and - no matter how they are financed - excessive national budget deficits would burden the overall current account position of the monetary union.

Securing convergence within the monetary union - with the retention of national currencies initially - will imply losses in independence in terms of national economic policy, i.e. a shift of responsibilities from the national to the Community level. This applies both to fiscal, economic, social and wages policy as well as - to a particularly marked extent - to monetary policy: ideally, within the monetary union national currencies are "perfect substitutes", i.e. market participants are indifferent as regards using the various existing currencies. The irrevocable fixing of parity rates under conditions of complete freedom of capital movements implies that national interest rate levels must converge (apart from minor differences arising from market imperfections). It will thus no longer be possible to conduct an independent national monetary policy that is geared to a national standard.

The basic stance of monetary policy must be laid down by a coordinating body at Community level. National central banks will then only be executive organs for the Community's monetary policy. To the extent that they are able to achieve the operational objectives laid down by the Community, the harmonisation of their instruments will not be necessary initially. This will in any case be possible only within limits in the preliminary stages since there are wide differences in existing structures of national money, credit and capital markets that will not disappear immediately even after the complete liberation of capital movements. However, owing to differing national transmission mechanisms of monetary policy as well as structural differences in the demand for money, it will be possible to achieve a uniform policy for monetary growth that is geared to a monetary target for the Community only gradually. Thus, as far as its practical application is concerned, national differences will persist. The creation of a uniform European money market which the central authority responsible for monetary policy can manage with instruments of its own will, however, be necessary at the latest when a common currency is introduced.

Monetary policy coordination needs to be complemented by the transfer of monetary relationships with the rest of the world to the Community level since the exchange rates of the partner currencies must develop uniformly. Exchange rate policy vis-à-vis third countries must therefore be laid down at the Community level, interventions on the foreign exchange market be decided jointly (with intervention operations being centralised at a national central bank or a common fund for reasons of expediency), and monetary reserves be pooled. In the field of international monetary policy the Community would act as a single entity. Instead of individual countries, it would then also need to be a member of the IMF.

Whereas the national states would necessarily lose their monetary policy independence in a monetary union, they can quite easily retain certain responsibilities in the field of fiscal and economic policy, as is the case in every federation of states. However, in order to exclude any doubts about the cohesion of the monetary union from the outset and at the same time avoid an overburdening of monetary policy, it must be ensured that there is a central authority for fiscal and economic policy parallel to the European central bank system that can ensure a large degree of conformity of action in these fields in all the member countries of the Community. This is because any lack of convergence that could give rise to expectations of parity changes would need to be "bridged" through interventions and interest rate policy adjustment measures on the national money markets in order to ensure the continuing existence of the monetary or exchange rate union. The deflationary or inflationary tendencies arising in the partner countries concerned could then be felt as a burden that would jeopardise the project of a monetary union in a way similar to the monetary "asymmetries" that is purported to exist by a number of partner countries in the EMS as it exists at present. This is what makes it necessary to transfer wide-ranging economic policy responsibilities from national authorities to Community organs.

In order to optimise economic policy as a whole the overall economic objectives for the monetary area should be laid down by a central European authority (roughly analogous to the Annual Economic Report of the Federal Government). Agreement would need to be reached on the policy mix, i.e. the combination of fiscal and monetary policy appropriate for achieving the overall economic objectives. This would also provide a basic guideline for each country's fiscal policy. Moreover, together with the creation of the single European market a far-reaching - but not necessarily complete - harmonisation of indirect taxes would be necessary in order to avoid competitive distortions. Although, given the existing low degree of mobility of income-earners, direct taxes do not need to be harmonised to the same extent, with unchanged shares of expenditure by the public sector in GNP, the harmonisation of indirect taxes will also create a need to adjust direct taxes as well as the overall burden of levies.

In the light of the structural imbalances within the Community, when parity rates are irrevocably fixed it will be necessary to create a system of "fiscal adjustment" through a Community organ in favour of the structurally weak member countries. Through such transfer payments the weaker members receive compensation for the burdens of adjustment associated with the definitive renouncement of devaluations as a means of maintaining their competitiveness. Thus, within the monetary union, balance of payments policy is replaced by regional policy, with the latter helping to finance intra-regional differences in current account positions through transfer payments. The differences in the level of economic development of individual member countries of the Community indicate that the necessary fiscal adjustment would require an extremely large volume of funds. Only through a very purposeful regional policy could these differences perhaps be reduced to an extent that is compatible with the existence of a monetary union.

Incomes policy must also take the fixing of parity rates within the monetary union into account. Divergences in regional developments (such as differing rates of increase in productivity or shifts in demand, for instance) require a correspondingly differentiated developmant of wages in so far as they are not offset by fiscal adjustment within the Community. Although regional imbalances can be offset through the mobility of the factors of production, this kind of adjustment would be associated with a shifting of capital and finally also of labour out of the less competitive regions that would be undesirable in terms of regional policy (and which owing to the far lesser degree of mobility of labour would not occur without frictions). Thus, given diverging developments in competitiveness, the renouncement of adjustments in exchange rates requires a differentiated wages policy, which would also need to cover ancillary wage costs. In branches of industry that manufacture their products under widely similar conditions a harmonisation of the development of nominal wages is to be expected within the monetary union in the absence of which diverging rates of inflation could arise. For this reason, even before the inception of the monetary union the basic willingness of both sides of industry to pursue a wages and incomes policy geared to the operating conditions of such a union must exist, especially bearing in mind that an increasing orientation of wage demands towards the highest level in the Community is to be expected within the monetary union. However, given the independent right to conclude collective wage agreements that is appropriate in an economic union based on the rules of free competition, the scope for economic policy to directly affect the development of wages and salaries is very restricted. Everything will therefore ultimately depend on a credible and rigorously pursued monetary policy that limits the scope for passing on cost increases and hence prevents excessive increases in nominal wages from occurring.

The economic policy implications of a monetary union can be summed up as follows: a monetary union presupposes considerable shifts in the responsibility for economic policy to a central authority and hence a far-reaching reshaping of the Community in political and institutional terms in the direction of a broader union. Although complete political union is not absolutely necessary for the establishment of a monetary union, the loss of national sovereignty in economic and monetary policy associated with it is so serious that it would probably be bearable only in the context of extremely close and irrevocable political integration. At all events, within a monetary union monetary policy can only be conducted at a Community level. A considerable degree of renouncement of independence will also be necessary in the field of fiscal policy.

B. Principles of a European Monetary Order

Eschewing technical institutional and monetary details, the following section outlines the decisive principles that absolutely must be taken into account when setting up a European central bank system. (For the sake of simplification, the point of departure is the final stage of monetary integration, namely the transition to a common European currency. However, the following criteria must also be fulfilled already at the stage when the monetary union is created, i.e. the irrevocable fixing of the parity rates of national currencies). The following principles appear to be indispensable:

1. The mandate of the central bank must be to maintain stability of the value of money as the prime objective of European monetary policy. While fulfilling this

task, it has to support general economic policy to the extent that this is laid down at Community level. Domestic stability of the value of money must take precedence over exchange rate stability. This does not exclude the possibility that depreciation vis-à-vis third currencies and the associated imports of inflation be counteracted by appropriate monetary policy measures. In the event of the establishment of an international monetary system with limited exchange rate flexibility vis-à-vis third currencies, the central bank would need to be given at least the right to participate in discussions on parity changes.

2. The overriding of the central bank to maintain the stability of the value of money must be safeguarded through its being independent of instructions from national governments and Community authorities. This simultaneously requires the personal independence of the members of the respective organs, assured by their being appointed to office for a period of at least 8 - 10 years without the possibility of their being removed from office for political reasons.

3. All the member countries would need to be represented in the monetary policy decision-making body, with voting power being weighted in the light of the economic importance of the member countries.

4. A federal structure of the central bank system - according to the pattern of the Federal Reserve System, for instance - would correspond best to the existing state of national sovereignty and would additionally strengthen the independence of the Central Bank. (Before the final stage involving the introduction of a uniform currency, only a federally

structured central bank system is conceivable in any case.)

5. The financing of public sector deficits by the Central Bank (apart from occasional cash advances) makes effective monetary control impossible over the long term. For a European Central Bank to be able to fulfil its mandate to ensure stability, strict limitations must be imposed on its granting credit to public authorities of all kinds (including Community authorities). This also applies to indirect government financing through the granting of credit to any central banks of the member countries that continue to exist.

6. The monetary policy instruments of the European central bank must be designed in such a way that they enable the money supply to be managed effectively without recourse to quantitative controls (or other forms of direct intervention in the workings of the financial markets). The instruments must correspondingly envisage means of conducting interest rate and liquidity policy that are appropriate both for the general management and for the fine-tuning of the European money market.

7. Banking supervision should be integrated with the independent European Central Bank. At least, the European Central Bank should be granted qualified rights to take part in the establishment of general regulations in the field of banking supervision. Moreover, owing to its expertise, deriving in particular from its business relations with credit institutions, the Central Bank should be closely involved in day-to-day banking supervisory activities.

## III. Models of monetary integration

### A. European Monetary Fund

The further development of the European Monetary Co-operation Fund (EMCF) to form a European Monetary Fund (EMF) as a kind of "Regional IMF" probably comes closest to the concept the architects of the EMS had in mind, seeing that in accordance with the Resolution of the European Council of 5th December 1987 the final system should be characterised by "the creation of the European Monetary Fund as well as the full utilisation of the ECU as a reserve asset and a means of settlement." In addition, the "existing credit mechanisms" will then be consolidated "into a single fund". Moreover, in conjunction with the conclusions relating to monetary policy reached at the meeting of the European Council in Bremen on 6th and 7th July 1987, besides US dollars and gold, "member currencies in an amount of a comparable order of magnitude" are also to be brought into the Fund. In the discussions in the years 1981/82 about the entry of the EMS into the final stage it was assumed that this could also constitute a final transfer of reserves.

A regional Reserve Fund with functions similar to those of the IMF would put this institution in a position to become involved in the process of balance of payments adjustment and financing on the part of its members. In this way, it could help to avoid recourse being taken to measures that disturb or delay the process of integration in the event of balance of payments difficulties. In the opinion of the proponents of such a Fund solution, the use of such balance of payments assistance as well as the resources made available by the Fund for the specific purpose of financing interventions could at the same time also help to stabilise exchange rate relationships within the EMS. If in the course of monetary integration it should come about that national external payments balances cease to exist and there is only a Community external payments balance instead then the Fund would have to support the process of adjustment and financing of the balance of payments with its resources.

the Community's imp? or regional imbalances.

In the case of a Fund along the lines of a "Regional IMF" whose policy would be primarily directed towards safeguarding the external balance of the Community member countries as well as exchange rate stability, the question arises as to the extent to which such a policy would also foster convergence within the Community on the basis of price stability. This possibility only exists in the case of conditional balance of payments credits being granted, i.e. when the consequences of insufficient convergence have already become evident. At stages prior to this, especially when providing resources for intervention purposes without any conditions attached, it could not impose any convergence constraints in the direction of non-inflationary growth in the Community. The danger that within the EMS the orientation towards domestic stability would be pushed into the background in favour of external stability - completely in line with the Balladur and Amato proposals - is obvious. Since the general thrust and coordination of economic, fiscal and monetary policy would play a role in this model of a Fund only at the margin (when conditional credits are granted) the stability-oriented monetary policy of the hard currency countries could be undermined. Moreover, mixing central bank functions together with areas of government responsibility within a single Fund bars the way to a European Central Bank with a decision-making body that is independent of governments; for my part, this is therefore to be rejected.

B. A European Parallel Currency

1. As an alternative to the gradual development towards a European monetary union - on the basis of a greater convergence of conomic policy, a growing coordination of monetary policy and an increasing renouncement of exchange rate realignments - the concept of a parallel currency has been under discussion since the mid-seventies. According to this concept, the driving force behind the process of integration should not be national governments or Community authorities but the market.

Alongside national Community currencies, an additional currency would be put into circulation which is able to fulfil all the functions of money (a means of payment, a unit of account, and a store of value) as far as possible. In the process, the parallel currency would be designed in such a way that - without being given preferential treatment - it is able not only to maintain its position alongside the national currencies but also to gradually crowd out the individual national currencies in line with the generally accepted pace of integration, and to do so by and large symmetrically. With the growing importance of the parallel currency, the national central banks would increasingly lose their scope for action in the field of monetary policy in favour of Community institutions since a growing proportion of the money in circulation in each country would no longer be under their control. Thus, this would de facto give rise to a loss of independence in the sphere of national monetary policy without any explicit shift in responsibilities to the Community level being necessary. This process would end with the abolition of the national currencies through a special sovereign act and the introduction of a single European currency.

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Compared with the familiarly difficult task of restricting national responsibility for economic policy through political acts, the idea of a parallel currency may appear to be quite "elegant" at first sight. It would correspond to the desire to undertake politically effective and symbolic steps (such as introducing a European currency, including the issuing of bank notes and coins, and setting up a European Central Bank) without demanding any great relinquishment of sovereignty at the outset. However, on closer inspection it becomes evident that this approach also requires an immediate and far-reaching need for changes in institutional terms if the "currency competition" that is set in motion is to proceed in a way that is acceptable for all the member countries. In this context, a large number of open and very complex questions arise. Agreement can be expressed with the authors of a recent study on the European Monetary System, Daniel Gros and Niels Thygesen, when they state that "the full logical implications of this approach were never drawn up at the official level."

2. Currency competition between the national Community currencies and a parallel currency can arise only if the parallel currency and each national currency are placed on an equal footing in all member countries with respect to their relevant functions. Besides the envisaged complete liberation of capital movements, i.e. the free use of each national Community currency and a parallel currency in external transactions, there would have to be equality of status for each national currency within the domestic economy as well. In order to ensure a sufficient degree of acceptance of the parallel currency as a means of payment its utilisation would have to be permissible for domestic economic transactions as well; however, its full recognition as legal tender would not

appear to be necessary. A harmonisation of exchange rate regulations would be required beforehand in order for an undesirable uneven distribution of the parallel currency not to come about from the start.

3. The economic effects of the introduction of a parallel currency depend on the concrete aspects of its design. On the basis of the existing European monetary unit, the ECU, a large number of parallel currency concepts with in part widely differing implications can be conceived of depending in each case on the criteria that are decisive - an independent status for the ECU as opposed to a basket definition, exchange rate regulations and the role to be played by central banks. As points of reference, two "interim solutions" of practical relevance constituting, on the one hand, the issuing of ECUs at the national level and, on the other hand, their being issued at the Community level are presented below: in the first case, the ECU is defined, as at present, as a basket of currencies with a fixed, but adjustable exchange rate (cf. type 1 in the table); in the second case, the ECU is an independently defined unit which would be put into circulation as an additional currency with a fixed, but adjustable exchange rate (type 2).

In contrast, the "present state" (basket ECU with a fixed, but adjustable exchange rate[1] without the systematic involvement of central banks in the private creation of ECUs) as well as the "final state" of a de facto monetary union (basket ECU or independently defined ECU with an absolutely fixed exchange rate) are not analysed in detail.[2] As far as the "present state" is concerned, on the basis of experience the purely private circulation of ECUs (which is only possible on the basis of a basket ECU) is of limited significance and such a restricted role of the ECU cannot contribute towards monetary integration. Section II already dealt extensively with the final state. In the case of immutably fixed exchange rates vis-à-vis the national EC currencies the ECU would not be a parallel currency but a dual currency; monetary union would then not be an objective still to be attained by means of the parallel currency but would already have been achieved. The difference between an independently defined ECU and a basket ECU would be meaningless in the final state with the result that this case does not need to be discussed any further.

4. As already mentioned above, with the parallel currency the objective is pursued of approaching the final state of a monetary union over the longer term through currencies

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[1] Ignoring the special role of the lira, sterling and the drachma.

[2] The independently defined ECU with a <u>flexible</u> exchange rate (type 3) propagated in scientific circles is also not examined because, although it is a model with theoretical advantages, it cannot be considered a realistic alternative.

that compete with each other[1]. In order for the parallel currency to have a chance in this competition among currencies it must be attractive from the point of view of individual economic agents as an investment currency (i.e. the net yield from the development of interest rates and exchange rates must be able to compete with the interest yield obtainable on assets invested in a national currency) and should not be inferior to the national currency as a transaction currency (i.e. the transaction costs and the exchange rate risk involved in cash management must be as low as possible). To the extent that a crowding out of the national currency occurs, this process must operate in the right direction, i.e. "good money" must not be replaced by "bad money" (Gresham's law) if price stability is to be maintained. How competition between the individual currencies actually develops and what monetary policy implications can be associated with it depends crucially on the way the parallel currency is designed in each case.

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[1] It appears doubtful whether the member countries actually are prepared to engage in unrestricted competition among currencies with all its consequences - including the crowding out of the national currency to a large extent. It can probably be realistically assumed that the national monetary authorities do not want to risk their currencies being crowded out of circulation in the domestic economy and will therefore keep the extent to which the parallel currency spreads under control by restricting its in one way or the other.

a) The basket ECU as a parallel currency (type 1)

As things stand today, the use of the ECU currency basket as a parallel currency while retaining fixed, but adjustable exchange rates vis-à-vis the individual national currencies appears to be the most obvious approach. The decisive step towards the introduction of such a parallel currency would consist in making it possible for ECUs to be created by the national central banks (in accordance with uniform directives) or by a Community monetary authority. The basket ECU would then be created not only - as is currently the case - by the private bundling together of the individual components but also through the granting of credit or intervention operations by the central banks or a Community monetary authority.

Under the conditions described above, (apart from third currencies) 12 national EC currencies and the basket ECU as an investment and external transaction currency together with two domestic transaction and accounting units would in this case be available to the citizens of the EC. With fixed, but adjustable exchange rates, the use of the basket ECU would depend on the risk and yield preferences of investors; although the ECU basket would be suitable as a diversification instrument, being the weighted average of the national currencies it cannot be superior to all other currencies or mixtures of currencies. With freedom of capital movements and persistent divergences within the EMS it is quite possible that the Deutsche Mark will be generally preferred as an investment currency and will crowd out both the ECU and other national currencies. Although with an increasing degree of convergence between the EC currencies the Deutsche Mark will lose its attractiveness for non-residents, the diversification motive for ECU-denominated investments will lose in importance at the same time. Investments denominated in foreign Community currencies would tend to be less profitable in the eyes of each country with the result that in both cases little speaks in favour of investments denominated in ECU.

or profitable as investment in ECU ?

In addition, the ability of the ECU as a transaction currency to crowd out national currencies within the domestic economy cannot be judged in much more positive terms either. Especially in the case of foreseeable divergences, the exchange rate risk involved would impair the use of the ECU for day-to-day transactions, for example through the constant need to determine exchange rates, irritating conversion rates and greater difficulty in agreeing prices on the part of domestic contractual partners who would have to take possible exchange rate risks into account if the contract is denominated in ECU. Even in the event of greater convergence, habits, the acquired "memory of prices" in national currency and similar factors tend to argue against the spread of the ECU. Thus, on balance, the best that can be expected is that the ECU would be increasingly used in intra-community trade as a "compromise currency", whereby, however, the crucial factor would probably not least be the negotiating position of the business partners concerned.

As a weighted average of national currencies, a basket ECU can therefore not exert any durable and especially any symmetrical pressure in the direction of crowding out national currencies and hence cannot be seen as an additional instrument for bringing about integration either. Precisely with respect to the fact that the attractiveness of a basket ECU is not assured as far as individual economic agents are concerned, it can be

Locking i.e. ex. rate of [illegible]

assumed that the EC central banks would be obliged to stabilise the exchange rate of such an ECU through unlimited purchases in order to foster the use of the ECU at least to this extent. (If, as is assumed, all the basket currencies are part of a system of fixed, but adjustable exchange rates then intervention points for the basket ECU vis-à-vis each individual national currency can be derived from their bilateral intervention points.) Should ECUs circulate on a relatively large scale, such an intervention obligation would have important consequences for monetary policy; in the final analysis, it would be tantamount to undertaking unlimited purchases of partner currencies without any settlement procedure and bringing about the integration of the circulation of official and private ECUs. If the market wanted to exchange ECUs for national currency then this would depress the exchange rate of the ECU against the currency in question. Through purchases to support the ECU the desired national currency will then be made available. As a result, ECU holdings would accumulate with the central banks whose currencies are in stronger demand than the currencies of its partners (or ECU) whereas the central banks responsible for issuing the currencies that are less in demand would have to issue ECUs by purchasing their own currency. On the assumption that divergences exist within the EMS, a de facto asymmetrical crowding out of the national currency concerned within Europe would come about. The national stability policy of the hard currency countries would be undermined. National price objectives would necessarily have to be sacrificed to the average rate of inflation in Europe. For these reasons, such a concept alone requires management of the money supply at the European level in order to ensure an equal rate of money creation (ECU plus national currency). Only in this way would it be possible to avoid a "dual coverage" of GDP in Europe through the circulation of ECUs and national currencies.

Moreover, redesigning the existing ECU to form a parallel currency would make it difficult to statistically record the national money supply if ECU bank notes were to be issued.[1)] Although it would be known how many ECU bank notes had been issued all in all, it would not be known how many of them are actually held in Germany of any other country. In addition, there would be exchange rate-induced fluctuations in the national money supply expressed in terms of national currency. Finally, account would also need to be taken of the general possibility that already exists today of shifting funds into offshore centres which might possibly play an even greater role for holdings of ECU than is the case with respect to national currencies. These reservations apply in equal measure to the independently defined ECU that is discussed below.

b) <u>An independently defined ECU as a parallel currency</u> (type 2)

In the case of an independently defined ECU with a fixed, but adjustable exchange rate vis-à-vis the Community currencies the development of the value of the parallel currency would be divorced from the development of the components forming the basket as it exists today but would depend on the frequency and extent of future realignments within the EMS. In principle, two possibilities exist as far as the exchange rate regulations governing an independently defined ECU are concerned:

[1)] The issuing of ECU bank notes would probably need to be expected even if the ECU were not to be declared legal tender.

On the one hand, the ECU can be made "superior" to the EMS currencies by laying down the parities and intervention points of the national currencies vis-à-vis the ECU as the focal point of the system. Their bilateral central rates would then be derived from the ECU parity of each national currency with the consequence that the bilateral margin of fluctuation between two national currencies would be twice as large as it is vis-à-vis the ECU (for example, a band of ± 1 1/8 % vis-à-vis the ECU would result in a bilateral band of ± 2 1/4 %). Thus, as a regional pivotal currency in the Community, the ECU would play a similar role in formal terms as the US dollar did in the former Bretton Woods system (without, however, having its own currency area as a base).

On the other hand, the independently defined ECU could be placed on the same footing as the national currencies; in this case, it would be treated as the currency of a thirteenth member country and would correspondingly have the same margin of fluctuation as the national currencies (whereby it could nevertheless be the focal point of the parity grid for computational purposes). Although the first variant would be of greater symbolic importance in the field of European politics and would foster the acceptance of the ECU as a parallel currency owing to its narrower margin of fluctuation, in principle both variants raise the same problems to a large extent.

As far as the ability of the ECU to crowd out other currencies is concerned, its being defined as an independent entity could potentially have both advantages and disadvantages because the new ECU could develop a priori more strongly than the strongest Community currency but could also develop more weakly than the weakest Community currency. In the absence of additional assumptions, such as equipping the parallel currency with a "value guarantee" (whereby, of course, only its use as an investment instrument but not as a borrowing instrument would be fostered) or assuring its usability worldwide, The ability of an independently defined ECU to crowd out other currencies as an investment instrument cannot be assessed conclusively. Ultimately, the decisive factor for the development of its value would be the extent to which ECUs are created by a Community authority (or by the national central banks of the Community member countries in accordance with uniform Community directives) in relation to the monetary demand for ECUs, which in turn would depend on the degree of acceptance of the ECU inside and outside the Community.

As is the case with a national currency, independently defined ECUs would be put into circulation through credits granted by the issuing authority/authorities to banks or public sector entities as well as through purchases of partner currencies or third currencies via interventions on the foreign exchange markets. In the final analysis, the governing factor in this process would need to be the monetary demand for ECUs which results from the use of the ECU as a currency in cash transactions, settlement operations and other payment transactions as well as for investment purposes in competition with each individual national currency.

It is, of course, difficult to assess the laws according to which such a monetary demand for ECU would crystalize. This would not least depend on how great the risk of a change in the value of ECU cash holdings is assessed to be in relation to holdings in national currency. Holding ECUs for transaction purposes would probably be a more attractive proposition in countries with a weak currency than in countries whose currencies tend to appreciate vis-à-vis the ECU. Economic agents in countries with a strong currency will at best hold ECUs for transaction purposes to the extent that they have to conclude and also settle contracts denominated in ECU in intra-community trade and payment transactions for competitive reasons. The wide use of the ECU as a currency by residents as an investment and reserve currency both inside and outside the Community would presuppose wide and deep markets as well as the willingness of bodies inside (and outside) the Community that enjoy confidence to incur debt in the ECU as a currency in a form and on conditions that appear advantageous to investors. However, a sufficient degree of acceptance on the part of investors - both inside and outside the Community - is to be expected only if the creation of the ECU as an independent currency is carefully limited by the central bank(s) responsible for this task.

The granting of an excessive amount of ECU credits to the national or Community fiscal authorities (for example, for the purpose of redistribution within the Community) in particular could lead to an over-supply of ECUs and ultimately to a deterioration in the value of the ECU vis-à-vis national currencies in the Community. This would not only impair the competitive chances of the ECU in relation to the national currencies. Owing to the obligations of the national central banks to intervene against the ECU, excess ECUs would also need to be taken out of the market by the central banks against national currency, which would make it difficult - if not impossible - for the countries concerned to conduct a monetary policy geared to stability. These risks to monetary policy would need to be assessed all the more carefully the more strongly the creation of ECUs were to be subject to political influences and the less flexible the exchange rate of the ECU were to be.

5. In the final analysis, a parallel currency strategy presupposes that the process whereby other currencies are crowded out through the free play of market forces actually does work. The requisite symmetrical substitution of all Community currencies (i.e. including the Deutsche Mark) by the parallel currency can come about only if the parallel currency
   - were given the same domestic status as every other Community currency;
   - could compete even with the strongest Community currency, taking interest rate and exchange rate developments into account;
   - involved minimum costs as a transaction currency, which would practically be the case only if it were pegged to the national currencies sufficiently firmly.

However, this more or less amounts to a definition of the final stage to which the parallel currency is supposed to lead in the first place.

The interim solutions comprising
- a basket ECU, or
- an independently defined ECU with fixed, but adjustable exchange rates

do not provide sufficient assurance that the process of integration would be free of tensions. On the contrary, they would involve the risk that national monetary policy would no longer be able to fulfil its mandate to ensure stability owing to larger-scale central bank interventions. In weighing up the costs and benefits of a parallel currency strategy the fact also needs to be taken into account that for day-to-day payment operations (cash transactions, settlement operations by machine, cashless payment transactions) a parallel currency would be entirely impractical. Ultimately, this leads to the conclusion that little would be gained in terms of European politics with a parallel currency but that much would be placed at risk in terms of stability policy.

C. A European monetary authority on the way to a single currency

If the concept of a "regional IMF" that was behind the original plans to create the EMS appears to be obsolete in the meantime and a European parallel currency is not an approach towards monetary union that deserves support, then it appears appropriate to prepare the prerequisites for introducing a single European currency at a later date by gradually harmonising the national currencies in qualitative terms. Such a development could be brought about by extending the role of the EC Committee of Governors. In this context, it is not absolutely necessary for it to become the management body of an EC monetary authority equipped with operational tools immediately; it could also exercise the function of a central decision-making body within a Community central bank system comprising the Committee and the national central banks of which it consists.

The Committee of Governors is particularly suitable for an extension of functions because (in contrast, for example, to the Administrative Council of the EMCF) it is de jure free from instructions. However, taking part in this Committee does not automatically annul the de facto dependence on instructions of individual Governors that exists under national law. It would therefore be desirable if this dependence could be gradually eliminated as the functions of the Committee are further extended and be replaced by increasing independence. As in the case of all other models, its mandate (maintaining the stability of money) and its status (freedom from instructions) should be assured at the outset.

Since the process of integration is to be seen as an evolutionary process, before decision-making responsibilities are transferred to supranational institutions the question should be examined as to whether additional possibilities to extend coordination exist and in which direction they lie. Above all, further steps appear conceivable and would also be useful where the present forms of cooperation are based mainly on an ex post exchange of information (policy vis-à-vis third currencies, changes in the field of supervision, laying down the interim objectives of monetary policy, etc.). They could gradually be developed into an ex ante exchange of information, such as is already occasionally practised on an informal basis.

In principle, the activity of the Committee of Governors (the title of which could be changed in the course of this process into "European Central Bank Council", for instance, in order to emphasise its importance) would be directed towards coordinating national objectives, individual decisions and the employment of monetary instruments. Based on current procedures, the degree of coordination could be gradually increased in the direction of obligatory advance consultations to the level of a kind of right to issue general directives.

In this way, the scope of freedom of national central banks or treasuries in the field of monetary policy would be gradually reduced. It would, for example, relate to aiming at intermediate objectives which are accepted in the process of coordination or are set later on as part of the right to issue directives. The scope for action would remain greatest in choosing appropriate instruments for achieving the objectives, but here again the Committee would have increasing possibilities over the course of time to exert influence with the aim of gradually harmonising the criteria on which the employment of certain instruments is based, extending to the creation of as uniform a set of instruments as possible.

As a kind of natural continuation of the tasks already undertaken by the Committee at present with respect to the exchange rates of the Community currencies in relation to each other and vis-à-vis third currencies, it would have to coordinate the intervention policy of the EC central banks with respect to the internal and external relationships of the Community, with a sufficient degree of exchange rate flexibility vis-à-vis third currencies being assured. In this context, account would need to be taken of the differing weights of the currencies within the EMS as well as their international role. Exchange rate policy vis-à-vis the rest of the world would have to take into consideration the fact that the third countries concerned (the United States and Japan) play a major part in determining the various exchange rate relationships. At a later stage, the Committee could assume the entire responsibility for influencing exchange rates that is provisionally a national responsibility, with the result that in the event of any foreign exchange market interventions, the national central banks would progressively operate in terms of "administering a mandate". The responsibility for determining central rates could also be transferred from the member governments to the Committee. In this way, there would be a greater possibility for proper decisions to be asserted against national interests and other influences.

A Committee of Governors with scope to influence exchange rate policy and monetary policy in the member countries could make an effective contribution to convergence that would foster integration. The objective behind the basic thrust of its policy would need to be to influence monetary policy in each member country in such a way that a symmetrical development is brought about on the basis of as great a degree of price stability as possible. The success of such an undertaking is indivisibly associated with comparable progress in terms of integration being achieved in fiscal policy and other areas relevant to economic policy.

## IV. Transitional problems

### A. Legal basis

Responsibilities in the field of economic and monetary policy have not yet been transferred to the European Community. The member states continue to be responsible for these spheres of policy; however, they do have the commitment to coordinate their policies (Sections 2, 104, 105 and 145 of the Treaty of Rome) in order to achieve their common objectives, to maintain a high level of employment and stability of the price level, to ensure equilibrium in the overall balance of payments and to maintain confidence in their currencies (Section 104 of the Treaty of Rome). A certain restriction for the member countries through Community law is to be seen in the fact that they should consider their exchange rate policies as a matter of common interest (Section 107 of the Treaty of Rome).

Restrictions that go further result from the rules governing the EMS. Leaving aside two Council Directives relating to the EMCF and the ECU, they are based on multilaterally agreed acts of self-restriction on the part of the central banks concerned and hence are not part of the legislation of the Community proper. In accordance with a regulation in respect of the Treaty (Section 102(a) of the Treaty of Rome) introduced together with the Single European Act of 1986, institutional changes in the field of economic and monetary policy undertaken in the course of further developments require the conclusion of a new Treaty under international law in accordance with Section 236 of the Treaty of Rome. How far an international Treaty is necessary in individual cases depends on the scope each central bank has in extending economic policy cooperation under its basis in law. This probably differs from country to country since the central banks in the individual member countries have a differing status in law.

(No definitive catalogue can be drawn up for Germany indicating which measure designed to further develop the EMS requires which act of legislation in each case. In abstract terms, the following guidelines can be set forth:

1. In Germany, under Section 24 of the Basic Law the transfer of sovereign rights to international institutions requires an Act of Parliament. This requirement of constitutional law is to be interpreted strictly (Federal Constitutional Law 58, p. 1 ff., and especially p. 35).

2. The Deutsche Bundesbank is able to strengthen monetary policy cooperation through greater cooperation among central banks only within limits. This limit would be reached if the Bundesbank were to subject itself to an external body - such as the Committee of Governors - with respect to a decision on monetary policy measures which is its duty to take. In doing so, it would relinquish the exercise of the authority it has under the Bundesbank Act. German public and administrative law assumes that a body that has been entrusted with tasks and responsibilities exercises these responsibilities directly; delegating them to another body is only possible if it is empowered to do so by law. It is also not permissible for such a body to link the decisions entrusted to it to the agreement of other bodies. In contrast, agreements and concertations are and remain possible.

3. The Deutsche Bundesbank is not able to establish a joint institution together with other central banks and grant it

powers in the field of monetary policy either; for this, owing to the lack of the necessary authorisation, it does not have the power of organisation required under public law.

4. Finally, on the basis of existing law, the Deutsche Bundesbank cannot transfer parts or all of its monetary reserves permanently and irrevocably to a common fund; such a transfer would go beyond the scope of the "operations" the Bank is allowed to conduct.)

Before national responsibilities are transferred to the Community sufficient clarity should exist as to the distribution of responsibilities at the Community level. The point behind this is to ensure that the principles of a European monetary order as described above have been put into effect at least in basic terms at every stage of integration. With respect to the position of the Community monetary authorities this means that no rights of any kind to issue instructions are granted to the political level and that an influence on national central banks does not accrue to the national political authorities to which they do not have a right under national law. This would speak in favour of making the Committee of EC central bank Governors, which is free from political instructions both at the national and the Community level, the starting point for further development in institutional terms. The members of this Committee would need to enjoy personal independence from bodies that appoint them, which admittedly also presupposes corresponding independence in their functions at the national level. In contrast, the EMCF, which is tied to directives issued by the EC Council of Ministers and hence is subject to political instructions, is not suitable as a monetary authority for a monetary order that is desirable from our point of view.

B. Integration in stages

Whether responsibilities in the field of monetary policy can be transferred to the Community level in several steps or in a single act of law depends on the concept on which integration is based. In principle, preference shoul be given to a global concept of integration with a clearly formulated final objective, as described above, with the individual steps being geared to this objective. A process of integration determined only by pragmatic considerations would not offer any guarantee that the final objective being striven for will actually be attained. It would be in accordance with this global concept of integration if the necessary authorisation were not to be restricted to individual steps in the process of integration but were to relate to the stage-by-stage plan as a whole, or at least to its major components. The member countries applied this procedure successfully in bringing about the customs union in the first decade of the Community's existence. However, experience with the plan of 1970 to achieve economic and monetary union in stages speak against setting a rigid timetable for the process of integration. Rather, institutional changes, which also include extensions in the spheres of responsibility of existing Community institutions, should be made dependent on qualitative progress towards convergence in the field of economic and monetary policy. The member countries would, of course, need to agree on a common procedure to determine whether the prerequisites have been fulfilled for the next stage towards economic and monetary union to be put into effect.

From a legal point of view, the establishment of an economic and monetary union in the Community does not depend on the existence of a political union. Rather, it is an accepted fact that the member countries of the Community can separate certain tasks from the multitude of responsibilities they have and transfer them to a supranational institution. They nevertheless continue to exist as states. They continue to pursue their own policies in major fields and have the necessary executive power to do so (territorial and individual sovereignty). To this extent, the jointly created supranational entity - in this case, the European Community - exists as an "association for the specific purpose of integrating certain functions".

As was already stated in the Werner Report of 1970, a lasting economic and monetary union requires the transfer of far-reaching responsibilities of national authorities to the Community plane above and beyond the direct field of monetary policy. An "association for the specific purpose of integrating certain functions" would therefore probably only be able to survive if it is supported by a far-reaching reshaping of the Community in political and institutional terms in the direction of a more comprehensive union. To this extent, progress towards economic, monetary and general political union is mutually independent and thus sets the framework in which progress in institutional terms appears possible.

C. Partial integration versus comprehensive integration

Important political reasons can also speak against integration by stages where individual groups of countries move towards integration at varying speeds. Endeavours should therefore be made to include all the Community member countries in the process of monetary integration. So long as considerable differentials exist within the

Community in terms of prosperity and productivity that are not offset to a large extent and in good time through corresponding transfers of resources in the context of fiscal adjustment within the union, movements in the factors of production between the various regions can occur as conditions similar to those in the domestic market are brought about. The more developed regions will be given impulses to growth at the expense of the periphery. To the extent that they do not prefer to allow themselves to be guided by general political considerations, this risk will probably deter a number of member countries of the Community from joining a monetary union. In contrast, a core group of countries, such as those comprising the members of the present EMS exchange rate system, appear to be quite strong enough in economic terms to agree to closer and closer ties with corresponding consequences in the field of economic policy.

The concept of integration by stages was practised under the "snake" system and is practised de facto within the EMS. Since monetary policy coordination took place in these systems up to now on a cooperative basis to a large extent the co-existence of differing rights and obligations in various countries did not impair cooperation. If, however, substantial progress towards integration is tied to major institutional bonds individual countries, by exercising their veto, could bring about a situation where such progress is made only on the basis of the lowest common denominator. The countries capable of integrating could escape this situation by agreeing on more rapid steps towards integration among themselves. In this case, the countries at the lower level of integration would no longer be able to participate in the monetary policy decision-making bodies of the Community on an equal basis as is the case at the present level of cooperation by means of a gentlemen's agreement. Only the countries prepared to subject themselves to its standards could have a claim to participate fully in the monetary union.

Integration by stages would be tantamount to dividing the Community into two parts which would not remain restricted to the monetary sphere as integration progressed but would also lead to the individual member countries of the Community having different rights and obligations. Although such a system of differing rights and obligations in individual spheres would not be considered to be incompatible with the Treaty of Rome, independent bodies of the monetary union would need to be created alongside the organs of the Community in order to meet the demands of the final objective. In the light of the present state of development of the European Community, this division between the level of cooperation and the level of integration would not only raise serious problems of a practical nature but the unification of Europe would gain a new quality through the partial integration of a number of core member countries as compared with the approach to integration adopted in the past. New hurdles would be raised for the countries on the periphery that would be increasingly difficult to take. The proponents of faster integration of the core member countries see this primarily as a transitional problem; they argue that, with the system being open to a corresponding extent, the countries initially excluded from this process could catch up with the train of integration later on when the economic prerequisites to do so have been created. However, the danger must not be dismissed that ultimately the differences between the member countries in economic terms will become cemented with the division of Europe into two parts in the field of monetary policy and in the related institutions . Although the pull of an incipient monetary union would be strong for the countries on the periphery, the high barriers to access to it might possibly frustrate their joining it in the long run. If the unification of Europe as a whole is also being striven for, then two-speed integration in the monetary sphere would tend to be an obstacle.

D. Integration under the Treaty of Rome or outside it

The stage-by-stage plan together with the description of the individual steps up to the final stage could be decided upon in a single package and extend the Treaty of Rome by the dimension comprising economic and monetary union. This "package solution" would have the advantage that it would be the subject of forming a political opinion in all the member countries only once and that it would not be necessary to negotiate the union several times over in "small coin" before the national legislative bodies, apart from the imponderables of the procedure as arose with the ratification of the Single European Act.

Through a "package solution" of this nature not only would the objectives be laid down in contractual form but the requisite responsibilities of the Community would also be envisaged. As a result, the issuing of "Regulations in unforeseen circumstances" under Section 235 of the Treaty of Rome would no longer be necessary. Arguments would be excluded on the issue, for instance, as to when "institutional changes" occur (cf. Section 102(a)) or whether a measure in the field of monetary policy is still accessible to - wide - interpretation under Section 235.

If, in the context of such an extended Treaty, a decision-making body decides to conclude one stage of integration and initiated the next step in monetary policy cooperation, then the question arises as to which body should be granted this responsibility. Several solutions to this question are conceivable. The Treaty already entrusts the Council with the authority to take decisions on such determinations in other cases (cf., for example, the determination of the Council with respect to the transitional period; Section 8 of the Treaty of Rome). In principle, the Commission could also be entrusted with making such a determination. As regards the technical expertise involved, however, the Committee of central bank Governors could also be considered for this task. A mixed body is conceivable as well.

However, if it is assumed that not all the member countries enter the integrational stage in the field of monetary policy at the same time, it will hardly be possible to grant these member countries the right to participate in the way it is designed. The countries engaged in the process of integration will not want to expose themselves to the risk of being partly governed by outsiders and expect that only those countries take part which expose themselves to the same risk. For this reason, it could prove to be necessary to lay down the corresponding rules among the active participants outside the Treaty of Rome initially. Basically speaking, this route was taken with the inception of the EMS. It would avoid the "systematics" of the Treaty of Rome and make monetary integration within the framework of the Committee of Governors possible which corresponds to the basic features of a European monetary order described above. In a later stage, ways would need to be discussed on how to harmonise the new set of rules with the Treaty of Rome.

The objection could be raised against bringing about monetary integration outside the Treaty of Rome that this approach would not correspond to the final objective of creating an economic and monetary union within the Community. As a result of Section 102(a), it could be argued, the member countries have undertaken a mandatory commitment to adopt the procedure laid down in Section 236 of the Treaty of Rome when they enter the institutional stage. They would have to refrain from all measures that could jeopardise the achievement of the objectives laid down in the Treaty of Rome (Section 5, Sub-section 2). The Commission will also have a considerable interest in incorporating the monetary policy institutions in the Treaty of Rome.

If the route prescribed under Section 236 of the Treaty of Rome is taken then the entry into force of changes in the Treaty is made dependent on their being ratified by all the member countries. An individual member country would then be in a position to prevent the institutionalisation of cooperation, or at least to delay it considerably.

## V. Concluding remarks

Since the inception of the EMS 9 years ago considerable progress has been possible in the Community in the field of monetary policy cooperation. In conjunction with the latest measures to establish an integrated financial area and the planned establishment of the single European market, the perspective of an economic and monetary union now appears in a favourable light again. Economic and monetary union would mark the end of a development which, despite all the considerable progress that has been made, will still take some time to achieve. Not all the member countries of the Community participate in the exchange rate mechanism of the EMS, and not all the participating countries subject themselves to the same conditions. The economic prerequisites for a monetary union that is characterised by immutably fixed exchange rates between the participating countries will probably not exist for the foreseeable future. Even among the members who form the nucleus of the exchange rate system, tensions must be repeatedly expected for the foreseeable future owing to differing economic policy preferences and constraints as well as to the resultant divergences in their economic development, which will make realignments in the central rates of their currencies necessary. Even within a common single market these problems will not simply disappear, especially seeing that this market will trigger additional structural adjustment constraints, the extent of which cannot as yet be fully assessed. For this reason, too, occasional realignments in central rates will not be completely indispensable for the foreseeable future. This indicates the necessity for further progress in the direction of greater convergence in a large number of macro-economic as well as structural fields.

The existing EC Committee of Governors offers itself as the basic unit in organisational terms of an EC monetary authority which does not threaten to run counter to the demands of the final stage at the outset. Responsibilities in the field of monetary policy could be increasingly transferred to it over the course of time. In the initial stage it would direct its activities towards coordinating national monetary policy objectives, individual decisions and the employment of monetary policy instruments. Parallel to this, it would ensure an increasingly greater degree of harmonisation of the exchange rate policies of the member countries. Working from the basis, its responsibilities could gradually be extended in the direction of obligatory advance consultations and go as far as having the right to issue directives on questions of monetary and exchange rate policy. A major factor in coordinating monetary policy at the Community level is the centralised process of shaping policy, which could be undertaken by the national central banks as the constituent parts of a European central bank system. In organisational terms, the Committee of Governors could be supported by its own enlarged secretariat.

Developing its own activities in the money and foreign exchange markets on the part of an EC monetary authority equipped with technical resources and staff as well as monetary policy instruments would not appear to be necessary until the national Community currencies have been abolished and a single European currency has been introduced. The step-by-step transition from a national to a Community monetary policy should take place on a legal basis that does not relate to individual steps in the process of integration but to this process as a whole. As far as possible, all the member countries of the Community should embark jointly on the path towards economic and monetary union in order not to handicap the integration of Europe as a whole at a later date.

If only a few Community member countries were to spur forward this would have serious economic and political consequences. Ultimately, the danger would exist of Western Europe being permanently divided into two parts if the barriers to access to the smaller system were to become too high. However, to the extent that separate action in Europe were politically desired, the door would have to be left open for the countries excluded in the initial stages to join later. <u>But these countries could not be granted any right to participate in the affairs of the monetary union.</u> Besides institutional arrangements of this nature, however, it is of outstanding importance for the success of monetary integration for the gradual transfer of monetary policy to the Community level to be accompanied by sufficient progress in the integration of economic and fiscal policy. Isolated steps in the monetary field would overburden monetary policy in political terms and jeopardise the credibility of the process of unification in the longer run.