Changing Targets and Strategies for the European Financial Integration

The call for a marked effort of deliberate European economic integration through a planned step-wise surrender of national sovereignty (Hague communiqué, Werner Plan) was the early answer to the Franco-German currency realignments of 1969 and to the end of the transitional phase of the Common Market. The international monetary scene has since undergone a series of massive shocks and transformations (abandonment of gold convertibility, two official devaluations of the dollar, floating of the main currencies, widely divergent inflationary pressures, reversal of manufacturing terms-of-trade vis-à-vis primary resources, revival of protectionism and exchange controls, soaring external indebtedness of most oil-importing countries, the 1974-75 deepest world recession — the worst in the postwar period). As a result, a wave of "disintegration" has apparently destroyed the image of an emerging European bloc as an alternative to the dollar-standard. And yet a fresh determined attempt to find feasible strategies for a more complete European integration seems the only reasonable alternative to a road headed for economic disaster and dangerous political and social tensions.

In the following pages I will try to lay down some basic propositions concerning aspects of monetary and financial integration, leaving aside other equally (or indeed more) important aspects, such as fiscal integration through a European budget, industrial and regional policies, and commercial and social policies.[1]

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1 Most arguments bearing on the various aspects of economic, and not only monetary and financial integration are thoroughly discussed in the main general reports issued in recent years: EC Commission, "European Economic Integration and Monetary Unification", *Study Group on Economic and Monetary Union*, Brussels, October 1973; Cairncross, A. K. - Giersch, H. - Petrilli, G. - Lamfalussy, A. - Uri, P., *Economic Policy for the European Community — The Way Forward*, Macmillan, London, 1975; EC Commission, *Report of the Study Group* "Economic and Monetary Union 1980", Brussels, March 1975 (hereafter referred to as the "Marjolin report").

I. Exchange-Rate Policy

1. - The supporters of a greater rigidity of intra-EEC exchange rates as one of the first steps towards monetary and economic integration have been, to say the least, disillusioned over the past three years. A considerable amount of confusion has arisen over the whole issue of currency unification, since arguments in favour of a European currency area *ex post* (i.e., assuming the full range of prerequisites as already in existence, from policy targets to policy instruments harmonization) have often been unduly extended to the transition, hence to the short and medium run. Now it is high time for governments to take a fresh look at this issue and candidly admit that a true European currency bloc, defined as irrevocably fixed intra-EEC parities with no allowance for either gradual adjustments or temporary floating, is both an undesirable and unfeasible strategy for European economic integration.

2. - It is undesirable, since different national trends in the demand for real output and in factor costs within the Community do require appropriate exchange rate corrections in order to avoid intolerable shifts in national overall competitiveness and hence to promote balanced growth throughout the area.

Even without making assumptions or judgments about the theoretical substitutability between exchange rate variations and income redistribution enforced through fiscal and regional policies within the area, the basic point remains that, in the foreseeable future, some corrections of the existing exchange rates among the 9 members cannot and should not be avoided.

Clearly these corrections do not represent a sufficient condition for curing structural disequilibria (see below, par. 6), but they do represent a necessary complementary measure for preventing a chronic shift of saving and incentive to invest from members faced with deficit-unemployment dilemmas to other members in opposite situations.

It should be noted that the balance-of-payments adjustment effect of exchange rate variations is only part of the story, and sometimes even gives a distorted mirror image of a more fundamental effect which consists of domestic and international profit redistribution.

From the domestic viewpoint, so the familiar arguments run,

exchange rate adjustments are a tool for achieving an "inward rebound" of inflationary pressures: the devaluing country unwinds its potential inflation (either of a demand-pull or cost-push nature) which under fixed rates was kept repressed (not corrected) because of international competition, whereas the revaluing country isolates itself from imported inflation. This implies a redistribution from wages to profits in the devaluing country, in particular to profits of firms producing exportables or import-substitute goods.[2] At the same time the revaluing country experiences a redistribution of profits from the export and import-competing sectors to the non-traded sector. Recent inflationary trends in Germany and Italy are eloquent enough on this point. As to the traded vs. non-traded sector redistribution, which is much harder to subject to empirical verification owing to scarcity of data, there is some evidence, albeit scanty.[3]

From the international viewpoint, for much the same reasons, exchange rate adjustments involve shifts in the comparative marginal efficiency of investment schedules, discouraging accumulation and parallel inflows of capital and labour in the surplus country, to the advantage of other areas. Trends in U.S. and Germany's direct investments before and after the dollar devaluation vis-à-vis the DM provide some evidence on this point.

As any policy aiming at pegging prices, the choice of irrevocably fixed parities calls for an adjustment of quantities which may turn out to be far more burdensome and inefficient, both from an economic and a political point of view. It may imply forcing labour to move to areas with investment opportunities and not viceversa, with all the well-known negative economic externalities and social costs.

On purely economic grounds, I would suggest that there is some analogy between the misallocations following the support of an exchange rate at an artificial level, and the pegging of the domestic

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2 But, as soon as domestic prices of exportables and import substitutes rise, the inflationary process spreads over the full range of prices, causing a redistribution in favour of firms operating in the non-traded sector as well. As for the money illusion counter-argument, see below, par. 5. Here I am leaving aside the positive effects of devaluation upon employment, which may be regarded as a redistribution of real income from the employed to the unemployed: see the writer's contribution in EC Commission, European Economic Integration, *op. cit.*, p. 155 of the English edition.

3 See DUNN, R. M., jr., "Flexible Exchange Rates and Traded Goods Prices: The Role of Oligopoly Pricing in the Canadian Experience", in Johnson, H. G. - Swoboda, A. K., eds., *The Economics of Common Currencies*, Proceedings of the Madrid Conference on Optimum Currency Areas, Allen & Unwin, London, 1973.

bond rate for allegedly stabilizing purposes of monetary policy. The latter easily leads to unwanted creation of monetary base, offset by capital outflows (hence a deficit in the balance of payments), and a shift in the public's preference from bonds to deposits in periods of rising short-term rates, with disrupting effects on credit creation.[4]

Finally, the undesirability of premature exchange rate rigidity stems from the danger that governments of deficit countries will resort to policy substitutes (tariff and non-tariff barriers, export subsidies or "voluntary" restraint), which are all potentially more disrupting than devaluations.[5]

3. - On the other hand, the strategy based upon the priority of a currency bloc appears to be unfeasible, for basically the following two reasons.

(A) The amount of official reserves in the hands of European monetary authorities, however pooled and taking account of a gold revaluation, is inadequate to resist mass waves of speculation (remember the first quarter of 1973),[6] whose potential today is greatly enhanced by frequent portfolio adjustments by oil-exporting countries in search of the most attractive currency mix.[7]

(B) Within the EEC, members in surplus will hardly accept a fully-fledged reserve pool before some sort of European political federation is started. This is all the more likely in the foreseeable

4 Italian monetary policy in recent years is a good case in point. Since 1966, Italian monetary authorities for two subsequent periods enacted a policy of pegging the bond rate, and twice had to give it up (in 1969 and 1974) in coincidence with periods of monetary tightening. This has caused — in the view of many observers — even harsher effects of credit squeeze and wealth misallocation, which could have been avoided if a more flexible and prompter reaction of long-term interest rates to market conditions had been allowed to take place.

5 Some evidence of this in the Ireland-UK currency area is presented by WHITAKER, *Monetary Integration: the Irish Experience*, Moorgate and Wall Street, 1973. See also the French experience in 1968.

6 In the first nine days of February 1973, the Bundesbank had to buy six billion dollars, following the upward floating of the Swiss Franc. On March 1 alone, following the second 10% devaluation of the dollar and before the temporary closing of the markets and the free floatation of the snake, the European central banks had to buy 3.6 billion dollars: see BLOOMFIELD, A. I.: "The Historical Setting", in Krause, L. B. - Salant, W. S., eds., *European Monetary Unification and Its Meaning for the U.S.*, The Brookings Institution, Washington, 1973.

7 In addition, there is the argument against the old definition of the U.S. "liquidity balance": in periods of widely spread exchange rate uncertainty holders of domestic assets also become potential speculators.

future, given the emerging pressure for marked shifts in the domestic political equilibria of some member countries (e.g., France, Italy and Denmark).

As far as the adequacy of reserves is concerned, it should also be remembered that the maintenance of a currency bloc implies that members in global (i.e., intra + extra EEC) surplus share their total surplus, not only that portion of it required to finance intra-EEC deficits with each remaining member.[8]

Finally, as long as official reserves remain national property, and therefore external accounts of member countries are not yet consolidated, the locking of intra-EEC exchange rates may increase the global deficit of some single country, so that the total need for reserves is likely to grow rather than fall.[9]

4. - Having recalled some reasons against currency unification as a starting point for economic integration, let now briefly consider the main arguments adduced in favour of that solution. I shall try to argue that they are either weak, or inapplicable to the transitional phase, or spurious and giving rise to dangerous confusions.

Among the weak arguments I would list the bulk of those which, with great elegance, have been derived from modern dovelopments of monetary theory: reducing the cost of information, restoring to European governments the seigniorage today accruing to international banks operating in the xenocurrency market, reserve saving (but see above) and so on.[10] These are hardly quantifiable arguments, and do not seem to carry much weight in comparison with the relevant list of costs and benefits deriving from currency unification.

Two more traditional arguments, which in my opinion cannot be applied to the process of economic integration, as against the final state of a unified currency area, are the following.

(A) Reducing traders' uncertainty within a highly commercially integrated area. This ceases to be true if expectations of some further

8 See SALANT, W. S., "Implications for International Reserves", in Krause-Salant, *op. cit.*, p. 217.

9 This point is correctly made by Kenen (in Krause-Salant, *op. cit*, p. 243), and is a useful reminder of the danger of too easy an acceptance of the well-known argument in favour of currency areas, based on economies of scale in the use of reserves.

10 See LAFFER, A. B., "Two Arguments for Fixed Rates", and MUNDELL, R. A., "Uncommon Arguments for Common Currencies", in Johnson-Swoboda, *op .cit.*, chapters 1 and 7.

intra-area parity adjustments are not eliminated, since uncertainty is then likely to be dangerously concentrated in some periods. Much the same reasoning applies to the adjustable-peg system as a source of international monetary disorder.

(B) Promoting smoother capital movements throughout the integrated area. But again, if member countries still have disequilibria which are not automatically financed (as would be the case within an interregional payment system), national governments are bound to resort to some sort of exchange control even vis-à-vis other member countries in order to support the parity. Thus, the virtue of a currency area would rapidly disappear. In section II on financial integration, I will take up this point again.

5. - Finally, I think even more "classical" arguments in favour of monetary union priority are based on very shaky grounds and have often caused considerable confusion.

First, the "monetary discipline" subject. The exchange rate constraint — it is contended — will induce member governments to coordinate their monetary policy targets and policies, and hence will avoid divergent inflationary trends and permit further, more decisive measures of economic integration.[11]

Here I am not taking issue with the (very controversial) opinion that different inflation rates stem from different monetary policies. It is simply that, looking at postwar records of Western European monetary policies, I cannot see how such an argument is empirically founded. There have been instances of highly expansionary monetary policies conducted under a formal commitment to maintain a given parity and leading to external deficits (e.g., France 1960-62 and 1967-68, Italy 1961-62 and 1971-72), as well as opposite instances of a strongly deflationary credit squeeze in periods of floating exchange rate (e.g., Italy and France in 1974-75).

One naïve though basic explanation, frequently forgotten by those preaching a peaceful monetary order under golden rules, is

11 Mundell is among the most articulate and outspoken supporters of this argument. Cf. the following quotation: "The exchange rate is a price, but it is not a price like the price of cabbage. It is a special price which *establishes the goal* of monetary policy, provides a basis for expectation of future policy, and this links the national money as a unit of account to the international price level. An exchange parity is an expression of the *long-run commitment* of the monetary authorities to a monetary policy" (my italics): Mundell, R. A., "A Plan for a European Currency", in Johnson-Swoboda, *op. cit.*, p. 149.

that governments and monetary authorities in Western democracies largely behave under the pressure of the majority opinion as expressed by the representatives of the political parties, business circles and the Trade Unions. This majority opinion may well regard economic expansion as a priority target and underrate the danger of inflationary spirals. Hence, policy-makers will refuse automatic rules conflicting with their preferences. Alternatively, practical events will lead the majority itself to become inflation-minded (as has happened in most oil-consuming countries after December 1973). Policy makers in the deficit country will therefore accept the inflation-devaluation mix under a flexible rate regime as a signal (indicator) at least as strong as reserve losses under a fixed rate regime. The latter situation is all the more likely if, under a regime of managed floating, the deficit country has to borrow from abroad in order to avoid sudden massive devaluations, because the burden of debt repayment soon becomes a hot issue. In any case, the idea of a monetary discipline imposed upon European governments by the allegiance to a scheme of rigid exchange rates, while political trade-offs remain completely separate, seems rather far-fetched.[12]

Second, consider the well-known "money illusion" argument in favour of currency unification among highly interdependent countries.[13] Taking into account both theory and observations in modern economies, one should never forget the following considerations.

(A) Even assuming a complete disappearance of the money illusion on the wage front, the erosion of real wealth following a devaluation may cause substantial expenditure-reducing effects (cf., Alexander's absorption approach).

(B) The same holds for all those non-wage incomes which are hardly protected at all against inflation, such as the earnings of many poor self-employed, income from capital, pensions[14] and most important for countries such as Italy with a dual labour market — for wages paid to workers belonging to the marginal segment of the market itself.

12 By this I am not playing against the argument for a stricter harmonization of the Community monetary policies, implying explicitly announced and more stable targets of domestic money creation.

13 Following the model suggested by McKinnon, R. I., "Optimum Currency Areas", *American Economic Review*, September 1963.

14 See Balassa, B., in Krause-Salant, *op. cit.*, p. 176.

(C) If a time dimension is introduced, as it must be when we are estimating the impact of frequent exchange rate corrections within the integrated area, the existence of lags between price and income increases may explain a *de facto*, though involuntary, " money illusion " behaviour.

(D) The crucial importance of relative, aside from absolute, wages in the preference function of wage-earners cannot be disregarded. There is not a unique national level of wages, but a whole structure of contractual and actual earnings, differentiated according to sector, location, size of the firm, sex, qualification, age and so on. Each category of money earnings is characterized by a different degree, if any, of downward inflexibility, and by a different responsiveness to unemployment. A reduction of real wages, through a devaluation-inflation process spread over the whole economy, is therefore likely to be more easily tolerated by broad-based Trade Unions than a jerky deceleration of money wage rates, unequally distributed among the various categories of wage earners (varying with the rapidity with which unemployment conditions caused by a deflation/fixed rate mix is felt in the various sectors).[15]

(E) The degree of " money illusion " is likely to differ as between labour markets of member countries, depending on different unemployment-inflation trade-offs in Trade Union preference functions, i.e. on the different weights assigned to the goal of raising real wages of fully-employed people rather than promoting a larger employment base. Think of the German Trade Unions vis-à-vis the Italian ones.

Third, factor mobility — often considered as a substitute for parity adjustments within an integrated area[16] — can be easily shown to be a tricky subject, like most applications of neo-classical wisdom to problems of economic development. On the one hand, capital mobility *per se* does not bring about an optimal resource allocation in dynamic and spatial terms.[17] On the other hand, labour

15 See Cooper, R. N., in Krause-Salant, *op. cit.*, pp. 200-201.

16 See the pioneering essay by Mundell, R. A., " The Theory of Optimum Currency Areas ", *American Economic Review*, November 1961.

17 This issue hinges upon the so-called complete or incomplete transfer process. A cogent case against fixed exchange rates in the presence of free capital flows, from the allocative viewpoint, is made in Modigliani, F. - Askari's article in this *Review*, December 1973.

mobility is both undesirable[18] and of limited practical relevance, as far as medium-run processes of intra-area adjustment of competitive conditions are concerned.

6. - While the currency unification strategy, therefore, does not stand up to close examination, both from a theoretical and a political viewpoint, one cannot ignore the fact that the generalized experience of frequent parity corrections and floating in industrial countries, over recent years, has seriously undermined many propositions long expounded by the believers in the optimality of a purely flexible rate system. This carries certain implications for our subject.

To put it briefly, I think recent experience has taught us that flexible rates by themselves cannot be a cure for fundamental disequilibria, although in general they provide the only feasible " lubricant " of the various adjustment processes. This reasoning may be put as follows.

(A) Flexible rates do (at least partially) insulate against imported inflation (think of Germany and Switzerland), but do not insulate an open economy from imported recessions (see the 1974-75 cycle in the OECD area). Of course neither are fixed rates *per se* a remedy in such a situation.

(B) So far as the deficit arises from structural shifts of the product-cycle type rather than from cyclical reasons (e.g., Italy and U.K.), unlimited recourse to successive devaluations or to downward floating may go too far in sustaining the " wrong " (mature) industries. In other words, flexible rates may reveal themselves as an efficient tool of adjustment but of a short and medium run nature, while the adjustment process implied by the dynamics of comparative advantages calls for complementary industrial strategies, more concerned with the supply side than with demand management, and designed with a long run horizon in view.

(C) Similarly, considering the impact of flexible rates on the capital account, one cannot rely upon devaluations as an incentive to attract long-term capital, unless the expected rate of profit is increased. Devaluation *per se* raises the rate of profit only in the short run (see above, the distributive effects).

(D) As has been widely acknowledged after the eruption of the oil crisis, when the deficit stems from an unfavorable shift in terms

18 For well-known reasons: see, among others, Cairncross et al., *op. cit.*, Ch. 6.

of trade exogeneously determined and the relevant elasticities of demand are low, flexible rates may lead to self-destructive and socially disrupting inflationary spyrals, accompanied by the well known perverse effects.

(E) Finally it must be honestly recognized that flexible rates do not allow for truly independent monetary policies in highly open economies, simply because governments are not prepared to accept substantial devaluations and revaluations, whenever alternative combinations of cyclical conditions and monetary policies in the rest of the world induce huge flows of trade-sensitive and interest rate-sensitive capital.[19]

(F) The foregoing considerations provide a solid case for managed floating, the prevailing regime today. It may function smoothly on the basis of some financial cooperation, while at the same time it does not require fully-fledged reserve-pool agreements among cooperating partners. Compensatory loans and central bank swaps may decently help monetary authorities in the integrated area to offset too heavy gyrations in exchange rates caused by short term shocks, either in current account (e.g., workers' strikes) or in capital account items (e.g., oil surpluses' portfolio shifts). Managed floating can also deal with phases of overreaction of the markets, following sizable exchange rate variations, which lead to the well-known J-curve behaviour of balance-of-payments accounts.[20]

19 Not surprisingly, this is largely recognized for the Canadian-US relationship: see, among others, DUNN, R. M., jr., "Exchange-Rate Rigidity, Investment Distortions, and the Failure of Bretton Woods", *Essays in International Finance*, n. 97, Princeton University Press, February 1973, p. 17, and the evidence here referred to. The behaviour of Japanese monetary authorities since 1971 is also quite paradigmatic: see YOSHINO, T., "Policy of the Central Bank Under the Floating Exchange-Rate System - Japan's Experience", unpublished paper presented at S.U.E.R.F. Colloquium "Floating Exchange Rates: What is to be Learned from Recent Experience?", Venice, October 10-13, 1974.

On this point, although not on other arguments presented to support of the Werner strategy, one may easily agree with INGRAM, J. C., "The Case for European Monetary Integration", *Essays in International Finance*, n. 98, Princeton University Press, April 1973, p. 8.

The heavy dependence of any conclusion as to the domestic impact of monetary policy upon different assumptions about exchange rate expectations is convincingly argued by ALIBER, R. Z., "Monetary Independence Under Floating Exchange Rates", *Journal of Finance*, May 1975, pp. 365-376.

20 It should be remembered that, among the various reasons which lie behind the J-curve profile of external accounts of either depreciating or appreciating countries, the recent experience has provided some evidence of the following:

(a) short-run rigidity of traders' price listings, so that the impact effect of a devaluation is a full rise of both import and export prices in the devaluing country's currency, and a corresponding zero change in prices of other countries. Thus the initial deficit of the devaluing country is at first magnified: at fixed quantities, an identical price increase in imports and exports makes the import surplus larger in absolute value (on this point see the recent literature on "currency contracts" and "pass-through" effects of devaluations);

(b) short run price elasticities of demand of traded goods are low. Hence the Marshall-Lerner case of perverse effects of devaluation obtains (for the oil-deficit case this also holds in the medium-run);

(c) if expectations of further devaluations (or revaluations) dominate the market, speculation takes place both in real terms (anticipated imports and delayed exports in the devaluing country) and in currency terms (leads and lags in trade payments and over-under invoicing of trade bills unfavourable to the devaluing country): see, for example, Italian-German trade in 1974).

21 ALIBER, R. Z., "Monetary Independence", *op. cit.*, stresses that uncertainty about future spot rates is indeed the necessary condition for assuring compatibility between differently phased national monetary policies, resulting in different levels of interest rates, and free capital mobility. On the unification of monetary policies among member countries, see below, par. 12.

Managed floating may be seen — to a considerable extent — as a disguised (undeclared) form of crawling-peg system. It may well represent the most reasonable transitory solution to an officially declared crawling-peg within the EEC, which in its turn theoretically represents the optimal choice for paving the way to an eventual currency unification. The greater uncertainty involved in managed floating vis-à-vis the crawling-peg does represent a cost, which however may be more than offset by the advantage of a more efficient defense against intra-area speculative flows, at times when monetary policies of member countries cannot be fully harmonized.[21]

7. - So much for the exchange rate controversy. Before trying to outline alternative strategies to foster European financial integration, I would like to stress that recent events have in fact increased the need for active steps by European governments. The whole issue of European economic union is far from having lost its momentum. In fact, the current deep and generalized recession has brought out more strongly the dangers of a positive economic integration unmatched by a normative (economic policy) integration.

EEC countries are increasing their degree of interdependence. A highly economically interdependent but politically disunited Europe is more likely than before to produce regional inequalities and incur a substantial cumulative loss of output, just because of the vicious circle of recession. Independent economic (and not only monetary) policies underlie the recent failures to find a balanced approach to European economic recovery. Germany's reluctance to

stimulate private domestic demand, the U.K.'s plunge into slump-flation, Italy's short-sighted alternation of fiscal/monetary expansion (stimulating a consumers' boom) and fiscal/monetary restriction induced by the balance-of-payments constraint (overkilling the investment cycle), France's pursuit of an independent energy and foreign economic policy while relying upon a substantial agricultural bill charged to other EEC partners: this deep-rooted fragmentation of cyclical and structural management of European economies is increasingly showing its inconsistencies in a period of painful adjustment to less favourable terms of trade, mounting social demand for a less unequal income distribution, and increased inflationary pressures. Beggar-my-neighbour solutions or sheer lack of coordination soon elicit the usual harmful repercussions, so that even member countries less constrained by balance-of-payments considerations, and less burdened with foreign debt, are drawn into a heavier recession.

As a result, the asymmetry between the economic power of the North-American economic union and of the European Community is likely to grow. Although the U.S.'s share of world GNP and trade has kept declining vis-à-vis the EEC share over the past 25 years, the leading U.S. role in the world cycle is still far from being challenged.

8. - The foregoing analysis leads to the following conclusions, as far as targets and strategies of European integration are concerned.

(1) Monetary unification will follow political unification, which will imply a basic consensus about "capitalism, socialism and democracy" in the European society. There is no reason why the European currency union should be an exception to the past historical records.[22] Of course, getting rid of the "currency bloc" approach does not exclude temporary joint floating, or various arrangements for managed fluctuations, or some scheme for a coordinated intra-EEC crawling-peg matched by larger flexibility towards external currencies.

(2) Leaving a certain degree of freedom to exchange rate and monetary policies is not incompatible with a positive search for a

22 As R. N. Cooper recalls, with the exception of the Scandinavian monetary union 1873-1915 which collapsed under divergent monetary pressures originating in the First World War, all currency unions have either followed political unification (e.g., U.S., Australia, Italy), or have been characterized by a single dominant partner (Switzerland-Liechtenstein, Belgium-Luxemburg: see Krause-Salant, *op. cit.*, p. 257. See also Cooper, R. N., "Monetary Unification in Europe: When and How?", *Morgan Guaranty Survey*, May 1972.

more substantial integration in other fields, including a certain amount of progressive unification (or creation *ex novo*) of policy instruments: see section II.

Unlike many observers, particularly in Brussels offices, I do not think that Monnet's strategy — of gradual steps in specific sectors which cause a limited political controversy but produce consistent spillovers into related sectors — is obsolete. It is basically a sound strategy, although less likely to function smoothly in a period of less easy growth (or indeed recession), more acute discrepancies in the national political scenes and — to some extent — a growing dualism between strong and weak regions. But, for the very same reasons, I submit that alternative approaches aiming at a "radical and almost instantaneous transformation"[23] are even less promising. Today national governments are less prone to symbolism, whose costs start being evaluated (see the CAP), and more aware that a straight obedience to the traditional rules of the game — as implied by a monetary unification preceding economic and political unity — is likely to benefit the dominant partners in productive and financial matters, at the expense of less favoured partners. Here I am talking not only of conflicts of interest between member countries, but more extensively of different segments within the European economy: e.g., skilled vs. unskilled labour, more concentrated and internationally diversified firms vs. small competitive firms, areas heavily specialized in financial intermediation vs. other areas.[24]

II. Financial Integration

I shall argue that substantial progress can be made in the field of financial integration, to the benefit of a more efficient management of the EEC economies in the present historical context, which does not imply either locking of intra-EEC parities, or rigid unification of member countries' national monetary policies.

9. - First, the necessity of an orderly recycling of European net trade deficits after the oil price rise (or, for this purpose, of any deficit which might be thrown upon European balance-of-payments

23 See Marjolin report, p. 5.

24 One of the few sectors which, at national and international level, perform better when most productive sectors feel the pinch of recession or of a credit squeeze.

by exogenous shocks on the international commercial scene) offers perhaps the greatest opportunity of creating a mechanism of financial intermediation under the responsibility of European monetary authorities. We have all witnessed the inconveniences arising from unevenly distributed recycling operations, left to private banking business or to episodic compensatory loans under government guarantees. The IMF and OECD initiatives are of paramount importance for providing a worldwide mediation; IMF oil facilities should be particularly available — more than has happened so far — to the real victims of the oil crisis, namely the oil-importing LDC's lacking both highly-valued natural resources and manufacturing exporting ability. The EEC initiative should first manage for a prompt and smooth allocation of oil surplus funds among member countries; [25] it might gradually play an increasing role as a borrower and lender of long-term funds with third countries.

A key feature of this proposal, already discussed in previous reports,[26] should be the adoption of a new European currency unit (basket of European currencies or SDR basket) for denominating loans and securities, in order to protect lenders and borrowers from the uncertainty of exchange rate variations. Europa-denominated bonds are likely to attract oil-exporting countries' funds and to improve European countries' ability to manage the recycling of their own deficits.

The maturity structure of the assets involved may be promptly adapted to the changing preferences shown by creditors, the debtors being official governmental agencies which may bear the risk of changing interest costs without undue difficulty. In addition, the availability of financial assets denominated in an attractive basket of currencies should induce investors of oil funds to lessen the high propensity to very short run maturities shown so far. The search for liquid investment opportunities, together with heavy portfolio shifts between the dollar and European currencies, in recent months

25 The Italian situation offers an indication of the limited scope of intra-EEC financing facilities so far. Over more than 13 billion dollars of external indebtedness (compensatory loans + loans " below the line ") outstanding at the end of August 1975, barely 3.4 billions represent official EEC cooperation (1.9 billions of the EEC " joint loan " + 1.5 billions directly from the Bundesbank).

26 See Magnifico, G. - Williamson, J., " European Monetary Integration ", *A Report of the Federal Trust Fund*, London, January 1972, and the reports referred to at the beginning.

can be largely explained by the lack of alternative exchange-riskless financial outlets.

The stimulation of such a broad European financial market might include indexed bonds, following well-known proposals, although the attractiveness of these securities rapidly fades when (as in 1975) expectations of a decelerating inflation take over the market.

Finally, it has been recognized that the extensive trade of Europa-denominated financial assets may rapidly spill over into the use of Europa as a parallel European currency, both in the public and in the private sector. I would simply express a note of disagreement about the proposal of defining the new common currency (Europa) in such a way as to make it at least as strong as the European strongest national currency.[27] If the goal is to encourage the use of Europa, from unit of account and official reserve to private financial asset and " monnaie cambiaire " for denominating contracts, one should be careful not to make it too attractive as a pure store of value. If chronic overvaluation prevents a money from performing the role of a vehicle currency — since overvaluation leads to excess supply of that money, increasing velocity, increase in prices denominated in that currency and hence ultimately to the disappearance of its real value — the existence of Gresham's law should remind us that a currency characterized by the opposite situation is hardly a good candidate either to perform that role. A chronic undervaluation vis-à-vis other world currencies would lead to an excess demand of Europa, and hence to a permanent surplus position of its issuer (the European Monetary Fund), since everybody would aim at being a creditor, not a debtor in this currency. Thus the Europa would not perform efficiently the very task assigned to it, namely an increasing intermediation between international borrowers and savers (and eventually within member countries).

10. - There is in addition scope for financial integration in the gradual unification of money market mechanisms and of instruments of monetary control. Without elaborating on the subject, let me stress that the gradual removal of controls on intra-area monetary flows, matched by the institution of an Exchange Equalization

27 See Marjolin report, p. 26; also Cairncross et al., *op. cit.*, ch. 2 (pp. 2-26 of the draft edition).

Account to allow for an orderly management of the intra-area exchange-rate policy,[28] should also be accompanied by efforts to promote a deep and resilient money market, by encouraging the public's access to modern instruments such as commercial paper, Treasury Bills of various maturities and so on. A well-functioning intra-community money market, besides enriching the range of available assets and liabilities of different maturity structures and different risk-yield combinations, seems particularly desirable, since in some member countries the oligopolistic structure of the banking system gives rise, in periods of monetary restraint, to sizable rents from intermediation at the expense of households and firms.

11. - A third, more controversial, area of financial integration, consists of a set of common banking regulations with regard to monetary flows with outside countries. I think that, aside from difficulties which might arise from an organizational viewpoint with regard to some member countries used to follow a "hands off" posture vis-à-vis international banking operations (but these difficulties should not be insurmountable in themselves), the basic reasoning is very simple.

Even assuming a perfect harmonization of monetary policies among EEC members and a smooth functioning of an EEC Stabilization Fund for helping an orderly management of the intra-EEC exchange rate policy, it is difficult to reconcile the plea for "discipline" in the conduct of EEC monetary policies with a "benign neglect" of the impact of short-term capital flows with non-EEC countries on the creation or distruction of the European monetary base. A careful management of the money supply cannot do without some degree of control on all sources of monetary base.

EEC flexible rates with the dollar and other outside currencies are indeed an important step towards lessening the degree of dependence from monetary policies abroad, particularly from U.S. policy, but involve the danger of forcing the EEC structure of exchange rates into heavy gyrations and prolonged over/undervaluations, which would be harmful to European business men and disastrous for the control of domestic inflationary spirals. An efficient planning of European industrial policies, concerned with shifts

28 See Marjolin report, ch. III-B-2. Some mechanism for the intra-EEC recycling of net short-term capital flows had also been advocated by various authors in EC COMMISSION, "European Economic Integration", *op. cit.*

in European comparative advantages, can also be seriously damaged by external parity adjustments due simply to large interest rate differentials stemming from divergent monetary policies in Europe and abroad.[29] This explains why governments, not being willing to accept the full implications of freely floating exchange rates in a world of highly sensitive international capital flows, do resort to interventions in the foreign exchange market, and, by so doing, give up their control of the foreign source of the domestic monetary base. The controversial "insulating power" of a flexible rate regime comes again under question.

If the enlarged EEC were really a "closed" economy vis-à-vis the dollar area, the loss of control of the foreign source of the monetary base could be tolerated, since it would be easily offset by the control of other sources (namely, monetary financing of public deficits and commercial banks' liabilities towards monetary authorities) or, alternatively, wide gyrations of the dollar exchange rate could be borne without undue stress on the growth and composition of the European output and the domestic control of inflation. But this does not seem to be the case, and it may be even less so in the future, if the impact of the "oil revolution" starts increasing the share of external trade vis-à-vis the share of intra-EEC trade, thus reversing a trend of the last two decades.[30]

In summary, an unlimited exposure of the EEC money market to short-term capital flows seems undesirable.

We now come to the question of the best solution. I think that a common set of regulations governing the European commercial banks' external position, which discourages or encourages net imbalances in bank claims and liabilities in non-EEC currencies in line with changing pressures from private capital movements, is a simpler and more efficient mechanism than direct exchange controls, such as flat refusals or freezings or zero-interest-rates on foreign deposits, or ceilings on credit to nonresidents.[31] Controls that hit

29 Remember, too, that exchange rate variations due to massive displacements of interest-sensitive capital flows soon trigger off additional flows in the same direction, owing to speculative expectations.

30 Does McKinnon's argument for optimum currency areas apply to the enlarged EEC today? The reversal in the shares of trade has indeed already taken place in 1974: see *The Economist*, August 23, 1975, p. 24.

31 According to Italy and France's experience, the central bank's control of the commercial banks' net foreign position seems to produce satisfactory results, in terms of checking an unwanted creation or destruction of monetary base through the foreign sector.

foreign and domestic investors directly, rather than banks' management of foreign operations, are likely to be more cumbersome, less efficient in the medium run and more discriminatory. Market forces can operate more freely and assure a better credit allocation if banks are left relatively free to adjust their foreign claims and liabilities to a prescribed net balance and simultaneously to changing cost-price incentives.[32]

No scheme of exchange control can guarantee complete effectiveness in the face of an almost unlimited ability of the market to devise ever new ingenious financial operations, to find new channels and to circumvent administrative rules. A crucial role in this regard is played by the network of banks and non-bank intermediaries located in Switzerland-Liechtenstein and Luxemburg, with the complacent assistance of their respective political authorities.

That is why measures acting through the market — such as the regulation of banks' net foreign position, reserve requirements on foreign deposits, flexible use of the discount window and of forward contracts on foreign exchange swaps between the central bank and commercial banks — are likely to be more effective than rules trying to act against the market.

12. - At the beginning of this section, I pointed out that a spurt to financial integration did not require a strict unification of national monetary policies within the Community. Together with close cooperation in the management of the European Stabilization Fund and an appropriate policy of publicly guaranteed compensatory loans through an expanding financial market, adjustments of intra-EEC exchange rates, should in fact permit monetary authorities in each member country to obtain and maintain liquidity conditions suitable to different domestic situations.

I would like to stress this point once again, because I sometimes find popular opinion in this regard rather puzzling. There is general agreement that, within a given country, a wise conduct of monetary policy should aim at matching credit supply to credit demand conditions across the various segments of the economy, or regions (defined as different "mixes" of operators and industries), provided the resulting supply of money is compatible with global policy constraints of price and balance-of-payments trends. Everybody would also agree that credit demand differs widely among regions, owing in the final analysis to different investment and saving conditions. (The relative position of I, S schedules, which determines the net financial claims and liabilities of the private and public sectors, reflects differences in factor costs, level of demand, profit expectations, taxation, etc.)

Now free capital mobility within the country should in principle ensure an optimal distribution of the available money supply among different uses, at the prevailing common level of interest rates. Yet in most countries monetary authorities try to go one better by having recourse to selective measures, such as rules on consumer credit, subsidized loans, discount window policy, sectoral incentives and so on. In periods of monetary tightening, monetary authorities also try to avoid credit rationing effects which penalize small competitive business at the expense of large-size oligopolistic firms; similarly, they try to offset the destabilizing impact of credit squeeze on sectors (e.g., housing) which are particularly sensitive to the short supply of funds in their medium-run development.

In such an enlarged and highly differentiated area as the EEC, the differences in credit demand conditions are not likely to be smaller than at the national level. Thus, the coexistence of different credit supply conditions (i.e., not uniform monetary policies), together with a free mobility of capital among member countries, may be seen as a counterpart of what will be a regionally and sectorally selective monetary policy, operated by a centralized European monetary authority, within a fully-fledged economic and monetary union.

The argument seems even more cogent at a European than at a single country level, if it is borne in mind that member countries' public budget deficits are of quite different a size in terms of GNP. Any given ratio of money supply to income, in each member country, therefore implies very different bank credit availabilities and cost conditions for private households and business of different countries. Hence those who plead for quick monetary unification and for an agreed anti-inflationary policy throughout the Community should

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It should be remembered that when, in recent years, Italian monetary authorities were induced to create an excessive amount of monetary base, this was brought about entirely by the financing of the spiralling public debt, while the foreign sector was destroying Italian bank reserves.

32 See McClam, W. D., "Present Interrelationships Between Money Markets and Foreign Exchange Markets", *Maandschrift Economie*, July 1970, reproduced in SUERF Series, Tilburg, 1970, for a balanced judgment on alternative uses of exchange controls and discriminatory credit policy.

also call for agreement on the distribution of the burden of financing national budget deficits.[33] On the other hand, different weights of the public deficit on the income of different member countries may be justified by different national targets in terms of demand management and supply of social goods. (Hence the proposal of a European budget, which should gradually supplement national budgets in various fields.)

Much confusion about the definition of "monetary discipline" and "monetary policy harmonization" stems — in my opinion — from a misleading interpretation of the propositions advanced by the advocates of the so called "monetary approach to the balance-of-payments" (MABP). In short, like any "reduced form" model which becomes tautological, the MABP is of little help in economic forecasting and planning, since it does not explain the determinants of the demand for money in a world of underutilized resources.[34] In the traditional MABP model, any creation of domestic financial assets has no impact on the real variables — and hence on the demand of domestic financial assets — since the balance of payments acts as a mechanical safety valve, which destroys or creates domestic liquidity according to any "excess" or "deficient" supply of money from domestic sources.

In conclusion, of the three basic meanings attributable to the words "monetary integration" — namely currency unification, monetary policy unification, financial integration — the latter should be the primary focus of discussion in the present transitional phase.

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33 Krause rightly points out that "the overall fiscal domain should correspond to the single monetary union": see KRAUSE, L. B., "Implications for Private Capital Markets", in Krause-Salant, *op. cit.*, p. 116. The point had ben already made by KENEN, P. B., "The Theory of Optimum Currency Areas: an Eclectic View", in Mundell, R. A. - Swoboda, A. K., eds., *Monetary Problems of the International Economy*, Chicago University Press, 1968, p. 46.

34 The full-employment assumption validates the theoretical underpinnings of the MABP model, but of course makes it far less relevant for economic policy purposes.