

The Political Economy of European Monetary Integration *

1. I must at the outset qualify the title of this lecture. First, I am aware that "political economy" is a much abused term: while often invoked to cover ambitious research programs, professional economists tend to associate it with loose thinking and shiver at its possible radical connotations. But the purpose of my exposition is very limited, and this may save me from sinning against the profession. The developments with which I shall deal have been largely dictated by political initiatives and decisions, or lack thereof; such initiatives however have concerned economic and even technical matters which naturally lend themselves to economic analysis. I wish to explore some aspects of the interplay between the political nature and the economic implications of the decisions, and occasionally ask if economic analysis has played any role.

There is a second qualification. I shall not be talking much, except in the last section, about Monetary Union in the proper and strict sense. I shall devote my attention more to what is already there, than to what is not. What is already there is the exchange rate agreement of the European Monetary System. I think I have good reasons for doing this. The birth and the subsequent developments of the system provide several interesting examples of an interaction between the economic implications of political behaviour and the political implications and consequences of economic constraints. Further, it would be impossible to imagine a progress towards European monetary union if the EMS were not in place.

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Let me now say how I intend to proceed. It is, I think, granted that the launch of the EMS, far from being the result of deep economic thinking, was the somewhat unexpected outcome of political initiative. There certainly were economic motivations and interests behind the move of Chancellor Schmidt and President Giscard d'Estaing: traditional European aversion to exchange rate instability; the incompatibility between the least savory features of the Common Agricultural Policy and floating exchange rates; the mistrust, after the collapse of Bretton Woods, of the domestic and external economic policy of the US at a time of "benign", or, as somebody said, "aggressive" neglect of the external consequences of a falling dollar; the hope by some to achieve greater price stability; the German interest in checking the appreciation of the Deutsche Mark. But the birth of the EMS can hardly find a satisfactory explanation in economic motivations, as is well documented,¹ and it would be useless, and vastly outside my competence, to go over the political history of that period once more.

I shall instead start by appraising the rather casual economic debate that took place when the EMS was launched and by examining some problems that were at the center of the negotiations in 1978. I draw two seemingly contradictory conclusions. Some economic and technical arguments used in the debate were either correct, but missing the political point, or irrelevant. On the other hand, when the EMS belatedly started, in March 1979, much of the political glamour had gone. The politicians' ambitions had been reduced to size by central bankers and officials, and little more than an adjustable peg system was set in place. This, however, is by no means the end of the story. Ten years of EMS have witnessed a subtler and more interesting form of interaction between politics and economics. Economic models have provided helpful insights, but have failed to fully capture the vagaries of history. The system has changed, as I shall argue. I shall conclude with a brief survey of the recent proposals for, and the debate on, a more ambitious monetary union, to see how it links with the EMS experience.

2. It has rightly been written that "when the EMS was launched in 1978... economists and policymakers still were influenced by the col-

¹ See especially PETER LUDLOW, *The Making of the European Monetary System*, Butterworth, 1982.

lapse of Bretton Woods. Because professionals were also attempting to understand the working of flexible exchange rates, there was no analysis of the EMS until the mid-1980s".² The concepts of time inconsistency and reputation, the games between governments and central banks were yet to flood the journals.

The debate that took place in the few months between the first proposal and the actual inception of the EMS was influenced by the somber economic climate prevailing at the time. The risk of a generalized recession, after the short-lived rebound in 1976, was thought to be far from negligible: the Americans were pressing Germany for reflating unilaterally, and, as the jargon went at the time, for being the locomotive (an episode still bitterly remembered by German politicians, officials, and commentators, who view the acquiescence to American pressures at the Bonn summit as a cause of the inflationary troubles). Inflation differentials between prospective members of the system were high and rising.

Lack of trust in the United States was widespread. Not only was the dollar weak, but the assumption, common to friends and foes of the EMS, was that it would remain weak and depreciate further: President Reagan with his confidence factor and his peculiar cocktail of policies was not yet in sight (nor were Mrs. Thatcher and her policies: the prospect of a weak pound helps understand the British decision not to join). A weak dollar meant of necessity a strong mark: linking one's currency to the mark was seen to imply the acceptance of appreciation with respect to third currencies, and, for higher inflation countries, of a deteriorating trade balance.

Supporters of the EMS would not dispute these assumptions. Some would argue that broader political considerations were of overriding importance with respect to a dry assessment of economic costs and benefits: the EMS initiative was the first sign of European life after years only spent bickering about budget contributions and the intervention price for butter; and there was the risk that a decision not to join at the start might become irreversible. I shall argue that, on the whole, they were right. Other arguments for joining were less acceptable, and sometimes less noble. As great weight was attached to the expected disciplinary effects of the

² FRANCESCO GIAVAZZI and ALBERTO GIOVANNINI, *Limiting Exchange Rate Flexibility: The European Monetary System*, MIT Press, 1989, p. 131.

system, it was hoped that, in the process, the political left would be reduced to size.

Hostility to or mistrust in the system, on the other hand, was not unjustified, given the prevailing (though mistaken) assumptions. In weaker countries, critics were rightly skeptical that the system could ever be a partnership of equals (the issue of symmetry, to which I shall return presently) and they were right. They further doubted the disciplinary benefits, which, they thought, could be achieved at less cost with suitable domestic policies.

Their dire predictions as to the output costs which the system would impose rested on the twin assumptions of inflexible exchange-rate discipline for member countries and of a weak and weakening dollar. Both assumptions proved untrue. The strong dollar and greater than expected flexibility reduced output costs, while allowing more time for disinflation: but it is a fact that for a long time the EMS remained a low pressure area, in terms of growth and employment, in the industrialized world.

The critics, however, erred on two counts. They assumed with unwarranted certainty that the conditions least favourable to the system would persist. More importantly, in assessing costs and benefits, they were deaf to political considerations which were instead relevant both *per se* and for a broader economic appraisal. Even leaving aside its sheer political impact, the EMS initiative, once it was seen to be irreversible, was bound to alter the set of conditions affecting expectations and the behaviour of economic variables. True, joining might not – as it did not – cause a sudden improvement of the economic climate in higher inflation countries. *Not* joining, however, may have been taken as a declaration of impotent inferiority and worsen that climate: commitment to disinflation outside the system would appear less credible.

If I am permitted a personal aside, I may be forgiven for having dealt at some length with the critics of the EMS initiative, as I was one of them eleven years ago. I expressed a contrary view with some vigour and, I hope, with some rigour; being then in Parliament, I cast my vote against a motion approving the belated Italian acceptance of EMS. Mr. Altiero Spinelli, one of the father figures of European integration, who was sitting with me in the same parliamentary group, voted in favour. Though he was not an economist, though his arguments were purely political, though almost all the conditions set

by Italy in the negotiations had been rejected, though the Italian debate and the behaviour of the government were marred by an unsavoury blend of what I defined the Tonio Kröger complex (of the small and brown towards the tall and blond) and of narrow domestic political considerations,³ I think that Mr. Spinelli was right, and I bear this in mind now that we are confronted with fresh choices regarding a stronger commitment to European monetary integration.

3. The critics were right in disbelieving that the EMS would be much different from earlier experiences of fixed exchange rates. Still, it was hoped by many (especially by the French) that the system would provide a symmetric solution to the *n*-th country problem.⁴

As with *n* countries only *n*-1 exchange rates need to be determined, one instrument is redundant over the number of objectives. In an ideally cooperative set-up, there is a commonly agreed objective. All countries are equal, in that all of them, and not only some, are expected to adjust: adjustment, therefore, may require more expansionary policies by some, and not only more restrictive policies by others. Such an ideal system has never existed in history, under an exchange-rate agreement. Asymmetry has prevailed, with a leading or dominant country using the degree of freedom provided by the *n*-th instrument to have an independent monetary policy in the pursuit of an independently set target. This was true of the Gold Standard, and even more of Bretton Woods.⁵

In the case of Bretton Woods, asymmetry was no longer accepted when the US started pursuing domestic objectives incompatible with price stability. In the case of EMS, on the contrary, it was feared that asymmetry would lead to an excess of discipline imposed by Germany: always adjusting to the leader would impose too great a burden on some countries. It was then thought that symmetry could

³ For an account of the events which led Italy first to suspend a decision and then to join, see LUIGI SPAVENTA, *Italy and the EMS*, Johns Hopkins Center, Bologna, Occasional Paper no. 32, 1978.

⁴ See ROBERT MUNDELL, "Problems of the International Monetary System", in R.A. Mundell and A.K. Swoboda, eds., *Monetary Problems of the International Economy*, University of Chicago Press, 1989.

⁵ See BARRY EICHENGREEN, "Hegemonic Stability Theories of the International Monetary System", *NBER Discussion Paper* no. 2193, March 1987; MASSIMO RUSSO and GIUSEPPE TULLIO, "Monetary Policy Coordination within the EMS: Is There a Rule?" in F. Giavazzi, S. Micossi, and M. Miller, eds., *The European Monetary System*, Cambridge University Press, 1988.

be achieved by finding some absolute measure of divergence. Such measure would help to determine whether the deviant policies were those of the stronger or of a weaker country: in the former case, the burden of adjustment would fall on the stronger country.

It was hoped that an objective yardstick could be obtained by conferring a new status upon an existing unit of account, the basket of European currencies called the European Currency Unit. The acronym Ecu was created, which pleased the French pride in their *grandeur*, and it was stated that "the ECU will be at the center of the system".⁶ It took little to show that the acronym could not provide economic meaning to an empty statement and that the quest for symmetry was illusory. The Bundesbank feared that an exchange rate link with untrustworthy and unruly partners like Italy would in any case complicate its task "die Währung zu sichern" and it was adamant in rejecting any suggestions that its policy could in any way be affected by contractual obligations and that *its own* behaviour might be singled out as deviant. On top of this, the search for an objective standard to measure divergence and to enforce symmetry proved to be, technically, a red herring. After endless discussions and a deluge of technical papers, an empty compromise was reached on an "indicator of divergence", now forgotten.⁷

In the end, the newly born creature was little more than an ordinary exchange-rate agreement: it set a grid of bilateral central parities, for which the expression of each currency's parity in terms of the Ecu was totally unnecessary, allowing for margins of fluctuations around the parity. In spite of some improvements regarding the procedures for parity realignments, the intervention rules and the financing mechanism for interventions at the margin, the system retained all the asymmetric features of previous experiences: Germany was the leading country; weaker members were left with the choice of either to keep the pace set by the leader or to change their central parity rate with the leader's currency.

4. The actual EMS, when born, was thus a far cry from the political ambitions entertained when it was conceived. One may be tempted

⁶ Annex to the conclusions of the Presidency of the European Council of 6 and 7 July 1978, in Bremen; Resolution of the European Council of 5 December 1978, para. 2.1.

⁷ See LUDLOW, *op. cit.*, chapters 5.2 and 6.2.

to conclude that this was the revenge of economics, or of hard technical facts, over politics in a broad sense. Such a conclusion would, however, be less than a half-truth: especially, it would be unable to account for some relevant developments of the system, both more recently and at an earlier stage.

In this section I shall first consider the policy, and political implications of the working of an asymmetric system of (non-irrevocably) fixed exchange rates, as it is described by recent economic analysis, and I shall then assess the actual performance of the EMS. In the following section I shall draw attention to some changes which are not fully revealed by economic models and statistical data.

A consistent body of recent literature on the EMS and related regimes⁸ shows how asymmetry may be the result of choice rather than constriction.

In this view, we have one country whose central bank has the strength and the determination to enforce price stability and enjoys a reputation of firm commitment to that objective. Another country (or more than one) is more inflation prone, because of past history or its own propensity: its central bank is unable, by itself, to affect agents' expectations and government's behaviour. This central bank may then seek the help of an external constraint in the pursuit of disinflation: requests of accommodation may be more easily resisted by invoking the argument that its hands are tied. The constraint consists in pegging the domestic currency to that of the stronger and more disciplined country. Behaviour inconsistent with the exchange rate target would cause a loss of reserves. The stronger country will not let its monetary policy be affected by this and will therefore sterilize the reserve inflow, leaving its monetary targets unchanged. The other country (or countries) are instead expected to adjust by accepting the contractionary effects of the loss of reserves. Thus, by pegging the exchange rate, the monetary authorities of weaker countries choose to relinquish their monetary independence, with the explicit purpose of "anchoring" to a more stable currency.

True, the option of devaluing remains open if discipline becomes too tight. But membership of an exchange rate agreement adds a

⁸ GIAVAZZI and GIOVANNINI, *op. cit.*, provide the most comprehensive account of this strand of literature. See also RUSSO and TULLIO, *op. cit.*, DANIEL GROS and NIELS THYGESEN, *The EMS: Achievements, Current Issues, and Directions for the Future*, CEPS, 1988; FRANCESCO GIAVAZZI and MARCO PAGANO, "The Advantage of Tying One's Hands: EMS Discipline and Central Bank Credibility", *European Economic Review*, June 1988.

political dimension to exchange rate changes: formal devaluation, unlike depreciation under floating rates, inflicts a political cost upon the home government. A high inflation country joining an asymmetric exchange rate system is thus seen behave like those addicts, who being unable to stop smoking and drinking if left on their own, seek some external imposition compelling them to behave as they should, but would not otherwise. The political implication is that the external constraint allows the central bank to prevail more easily upon other economic and political interests.

This model does not claim that stabilization thus achieved is costless. Until inflation rates have converged, there will be output losses. It is, however, argued that this particular way of achieving stabilization may be less costly than others: an exchange rate target may be more credible than, say, an independently set monetary target; if so, expectations will adapt more quickly, speeding the pace of disinflation.⁹

Has the system actually worked in the way described by the model? Theory is useful for uncovering and understanding important relationships, but its straightjacket never quite fits the variegated developments of history.

In the first years of the EMS inflation differentials with Germany, far from narrowing, increased in the case of France and, especially, of Italy. Until the early 80s monetary policies and expectations were but little affected by membership in the system. EMS discipline was fairly relaxed: between 1979 and 1983 there were seven realignments, while France and Italy kept in place severe capital controls. This flexibility was important for the system's survival in spite of the remarkable difference in initial conditions; but it also lessened its disciplinary effects. True, some effects were felt also in the first half of the 80s. As central parity changes, however numerous, never quite accommodated inflation differentials, the real effective exchange rates of weaker currencies appreciated within Europe, while Germany's competitiveness increased. This suited Germany (in purely economic terms this was the price exacted for the good of price stability she undertook to provide); in weaker

⁹ Whether exchange rate appreciation reduces the output cost of disinflation is discussed in STANLEY FISCHER, "Real Variables, the Exchange Rate, and Indexation: Real Variables in Disinflation", *The Quarterly Journal of Economics*, February 1988. See also the discussion in GIAVAZZI and GIOVANNINI, *op. cit.*, ch. 5.

countries it served to squeeze industrial firms and force them to resist wage claims and cut their costs. In spite of this, it is hard, however, to detect the rapid change of regime predicted by theory.¹⁰

After the early 80s a remarkable convergence in inflation rates did indeed occur: the differential with Germany fell from the double-digit figures to 3-4 points around 1981. Quick, or quicker, disinflation took place, however, also in other non-EMS countries, and in particular in the UK. It is still an open econometric problem to decide to what extent the French or Italian disinflation can be attributed to the EMS.¹¹ It has even been argued that quicker disinflation in the US and the UK was achieved because those two countries did *not* have exchange rate obligations and were therefore able to engineer a much higher real appreciation of their currencies.¹² In the case of the UK, the latter argument neglects the depth of the recession caused by the steep appreciation of the pound.¹³ As for EMS countries, they were greatly helped by the economic policies of the Reagan administration. Europeans have been fond of blaming such policies, but they must thank fiscal expansion in the US and the strong dollar for whatever modest export-led growth they managed to achieve in the mid-80s.

5. If we thus confine our attention to statistical data, it is indeed difficult to assess the effects of the EMS against the model's predictions.

I surmise, however, that the evolution of the system and the policy and political changes which have accompanied it have been deeper than what time series reveal and more far-reaching than the model would tell. A regime change has occurred. Episodes of policy

¹⁰ See SUSAN M. COLLINS, "Inflation and the European Monetary System", in Francesco Giavazzi, Stefano Micossi, and Marcus Miller, eds., *The European Monetary System*, *cit.* Also GIAVAZZI and GIOVANNINI, *op. cit.*, ch. 5 do not detect a shift in regime in their econometric estimates for the first years of the EMS.

¹¹ See SUSAN M. COLLINS, *op. cit.* In the "Introduction" to the same volume NIELS THYGESEN notes that "it is not surprising that econometric techniques fail to uncover dramatic shifts in wage-price behaviour following the start of the EMS": as "the system was initially fairly soft", "a tight disinflationary mechanism was not - and could not have been - perceived in the first 3-4 years" (p. 8).

¹² PAUL DE GRAUWE, "The Cost of Disinflation and the European Monetary System", *CEPR Discussion Paper* no. 326, July 1989.

¹³ For a comparison of the Italian and the British experience, see FRANCESCO GIAVAZZI and LUIGI SPAVENTA, "Italy: The real effects of inflation and disinflation", *Economic Policy*, April 1989.

turn-arounds often mark the watershed; then, as commitment to the EMS has become more credible, the mode of working of the system has changed. Some old problems have thus lost relevance, while new ones have appeared on the horizon.

Perhaps the most evident example of policy turn-around is to be found in the case of France in 1981-83, when the Socialist government of President Mitterrand made the impossible, though generous, attempt of reflation in one country: generous, because Europe was in a slump and unemployment was rising everywhere; impossible, because reflation was undertaken by a follower, and not by the leader in the EMS. Fiscal expansion (on top of nationalizations) quickly met with heavy retribution. Capital outflows and a currency crisis made it clear that the Socialist objectives – expansionary policies – were incompatible with membership in the EMS. As “membership of the EMS [was] invested with enormous political importance at the highest levels of government”, the choice was turning to austerity.¹⁴ The effects of that lesson have been long lasting. After that, the French Socialists have become *plus royaliste que le roi* in their allegiance to fiscal discipline and EMS obligations.

Another, perhaps less obvious, example is provided by Italy. Between 1983 and 1984 the government (headed by a Socialist) attempted to reduce the degree of wage indexation, in order to lower inflation. Failing an agreement with the major trade union, the government intervened by decree, setting a ceiling to indexation for only one year. This quantitatively modest measure was taken as an unexpected and unusual signal of firmness. Moreover, the opposition called a national referendum to repeal the measure and was defeated. Expectations were affected far more than the modest effects of the measure would justify, and the pace of disinflation quickened.

EMS membership precipitated the French crisis. It is otherwise a matter of speculation to assess whether and to what extent sudden policy changes in France or in Italy (and in Ireland in 1982) were associated with the EMS. It is probably true that, for a sizeable shift in expectations to occur, pegging the exchange rate is by itself insufficient and that more evident proofs that governments are ready to enforce unpopular policies are needed; but it is also fair to say that the EMS did help to provide a justification for such policies.¹⁵

¹⁴ JEFFREY SACHS and CHARLES WYPLOSZ, “The Economic Consequences of President Mitterrand”, *Economic Policy*, October 1986.

¹⁵ See GIAVAZZI and SPAVENTA, *cit.* and GIAVAZZI and GIOVANNINI, *op. cit.*, ch. 5.

Later in the 80s, deeper and more important factors have been at work, which have been strengthened by the EMS, while at the same time strengthening the system. The novel development has been a drastic and possibly irreversible change in the political, or more precisely the politicians', attitudes towards inflation.¹⁶ In game-theoretical literature on macropolicies it is customary to assume that unemployment ranks high in the loss function of the government, while inflation ranks high in that of the central bank – whence a difference of objectives between the two players. These models would misrepresent the situation in many European countries today. Whether because of the influence of modern economic theory, or because of a shift in voters' preferences, or because of the strength of international consensus, everywhere in Europe a reduction both in the inflation rate and of its differential with respect to the lowest inflation country has come to be considered a far more desirable feather in the politician's cap than, say, a decrease of half a point in the unemployment rate. The result of this has been that central banks have gained far greater independence in, and obtained political support for, the pursuit of monetary policies aimed at the control of inflation. This has especially been the case in countries with higher inflation rates where the process of disinflation has succeeded in reducing, but not eliminating, inflation differentials.

An ingredient in the programme has been the maintenance of relatively stable exchange rates with the Deutsche Mark. While in the first four years of the EMS there had been seven realignments, there have been only two since 1983, and almost three years have elapsed since the last one. Unlike in the past, strong speculative attacks against weaker currencies, like the French franc or the lira, have been resisted obstinately; German offers of an across-the-board appreciation of her currency, so often solicited in the past, have been turned down. In short, aversion to parity changes, once confined to the smaller and Northern members, is now shared by all, including Spain, the newcomer. This is all the more remarkable in view of two facts: capital controls in weaker countries have to a considerable extent been removed, and will be completely eliminated by July 1990;

¹⁶ See LUIGI SPAVENTA, “The New EMS: Symmetry without Coordination”, paper presented at the conference “Managing the EMS in an Integrated Europe”, Madrid, 11-12 May 1989 (a summary is in *The European Monetary System in Transition*, a CEPR Report, September 1989).

the convergence of infra-EMS inflation rates has come to an end, and inflation differentials with Germany persist to a varying degree. Freedom of capital movements and inflation differentials would seem incompatible with prolonged stability of exchange rates; the system instead has never appeared as stable. This has moreover occurred without damaging growth in the weaker countries: Italy and Spain have grown faster than the others.

These developments raise some interesting analytical problems;¹⁷ here I shall only list some features and implications. Central banks of weaker countries, in their newly found independence, have kept a tight stance of monetary policies to keep domestic demand in check and have set accordingly the level of interest rates. In so doing they have overfulfilled the exchange rate objective. This has happened because the degree of monetary stringency necessary to defend a given exchange rate is not uniquely determined, but depends on the credibility of the commitment to exchange rate stability. As realignments have become more rare and long periods have elapsed without parity changes, credibility has increased, while the tight stance of monetary policies has not been relaxed. High nominal interest rates coupled with rapidly declining expectation of currency depreciation have stimulated massive capital inflows towards "weaker" currencies. Central banks of "weaker" members of the system have sterilized the reserve inflows in order not to overshoot their monetary targets: when this has proved too difficult, they have allowed some appreciation of the exchange rate within the band.

These apparently paradoxical developments have important implications. One concerns the mode of working of the system. The nominal anchor of a stable exchange rate with the strong currency has been supplemented by tight domestic anchors, autonomously set by each country's central banks. The old problem of asymmetry thus seems to have disappeared. Without any institutional change, the EMS has become more of a club of equals: it may even happen that the former leader becomes at times the passive subject of portfolio shocks, while the others, having learnt the basic principles of good monetary manners, are now allowed to set their rules of behaviour independently. This new mode of working of the system poses, however, new problems. The most evident arises from growing trade

¹⁷ An attempt to deal with them can be found in FRANCESCO GIAVAZZI and LUIGI SPAVENTA, "The New EMS" *CEPR Discussion Paper* no. 369, January 1990.

imbalances within the EMS:¹⁸ the German trade surplus towards the rest of Europe grows rapidly, at the expense of countries where stable exchange rates coupled with persistent inflation differentials cause a real appreciation and where demand grows faster.

Further, the present set-up provides no incentive to a reduction of fiscal imbalances in the countries which are the recipients of capital inflows: a strong exchange rate and rising foreign exchange reserves obscure the fiscal problems just when fiscal restraint would be required to eliminate the imbalances.

6. Where do these developments leave us? How are they connected with the new drive towards monetary union, initiated at the Hannover council of 1988, which has found a first expression in the Delors Report?

In the words of the Delors Report,¹⁹ Economic and Monetary Union (EMU) "would imply complete freedom of movement for persons, goods, services and capital, as well as irrevocably fixed exchange rates between national currencies and, finally, a single currency". This in turn would imply a common monetary policy and consistent policies in other areas: whence the need for a gradual transfer of decision-making power from member states to Community bodies, especially in the monetary field.

The Delors Report divides this process into three stages, the last of which clearly belongs to a very vague and distant future. The first stage would impose rather limited requirements: there are provisions for strengthening coordination and mutual surveillance of macroeconomic, and especially of fiscal performances; "realignments of exchange rates would still be possible", but an effort would be made to improve the functioning of alternative adjustment instruments; the role of the (already existing) Committee of Central Bank Governors would be enhanced though its recommendations would not be binding.²⁰

¹⁸ See STEFANO VONA and LORENZO BINI SMAGHI, "Economic Growth and Exchange Rates in the European Monetary System: Their Trade Effects in a Changing External Environment", in Giavazzi, Micossi and Miller, eds., *op. cit.*

¹⁹ Committee on the Study of Economic and Monetary Union (DELORS COMMITTEE), *Report on Economic and Monetary Union in the European Community*, Office for Official Publications in the European Community, 1989, par. 16.

²⁰ *Ibid.*, para 52.

Stage Two, for which the Report does not propose a detailed blueprint, has been labelled as a "soft union":²¹ a period of transition which would allow "a training process leading to collective decision-making, while the ultimate responsibility for policy decisions would [still] remain with national authorities".²² There would be more precise, though not binding, rules relating to budget deficits and their financing. Exchange rate realignments would still be allowed, though only in exceptional circumstances. The main novelty is the institution of a European System of Central Banks, whose main task "would be to begin the transition from the coordination of independent monetary policies... to the formulation and implementation of a common monetary policy":²³ at this stage the responsibility would still remain with national authorities, but with the understanding that "national monetary policies would be executed in accordance with [the] global guidelines" set by the ESCB; there would be a common operational framework and a certain amount of foreign exchange reserves would be pooled. (I omit stage three, because of its remoteness and its vagueness.)

Neglecting a number of specific questions, there is one general problem which deserves attention because it links the EMS, as it has evolved, with this new ambitious initiative.

Do "economic union and monetary union form *two integral parts of a single whole*", to be implemented in parallel, as stated by the Report?²⁴ In point of doctrine the answer is negative: free trade areas are quite compatible with, say, floating exchange rates, and certainly they are compatible with multiple national currencies.²⁵ Irrevocably fixed rates may serve to prevent the destabilizing effects of free capital movements: we have seen, however, that a credible commitment to stable rates, as is already perceived now, may be sufficient to prevent portfolio shocks against the weaker countries.

²¹ NIELS THYGESEN, "Institutional Developments in the Evolution from EMS Towards EMU," paper for the conference "The European Monetary System in the 1990's", Athens, August 31-September 2, 1989.

²² *Report on Economic and Monetary Union in the European Community*, cit., para. 55.

²³ *Ibid.*, para. 57.

²⁴ *Ibid.*, para. 21.

²⁵ See the discussion in BARRY EICHENGREEN, "One Money for Europe? Conceptual Issues and Lessons from the U.S. Currency Union", paper presented at the Economic Policy Panel Meeting, London, October 19-20, 1989.

The more relevant explanation of the drive towards monetary union must be sought in the recent developments both of domestic policies and of the EMS which I have briefly reported. *De facto* a political choice of exchange rate stability, greater than requested by the Delors Report in the first stage, has already been made – in all major EEC countries but one – and is already being implemented. It may seem paradoxical that, though the EMS was little more than an exchange-rate agreement, and a relatively modest affair in comparison with the ambitions of EMU, the choice of supporting the latter has aroused little debate (more often, it has been accompanied by tiresome eulogies from all sides), while the choice of joining the EMS was, as I recalled at the beginning, the object of heated discussions. But there is no paradox. For countries like France and Italy joining the EMS was indeed a relevant change, because it implied a sudden shift of the exchange rate regime and important changes in the conduct of domestic policies. The choice appears far less dramatic now, after three years of stable exchange rates and of voluntary convergence of monetary policies. Precisely the same reasons help to understand – though this is only part of the explanation – the dramatization of the issue in the UK, a non-member of the EMS, where the state of the debate reflects a lag of several years with respect to developments in the EMS members.²⁶

What is then the hue and cry on EMU about? In point of fact, it may legitimately be said that the first stage envisaged by the Delors Report has already quietly been reached – without any formal decision and without any publicized innovation of the institutional mechanisms of cooperation and surveillance. Informal cooperation between central banks in the EMS has already improved considerably, especially after a 1987 agreement concerning the financing of intervention and the coordination of interest rate policies. True, in the fiscal policy area so far there has been little, if any, coordination, and surveillance has been ineffective. Stage one, however, would hardly improve upon the present situation: fiscal policy and budgets belong entirely to a political process on which central banks have no direct say; further, the link between deficits and the exchange rate target in the short run is tenuous, and has become more tenuous as the credibility of the target has stimulated capital movements towards the high-deficit and high interest rate countries.

²⁶ See an excellent account in MICHAEL ARTIS, "The United Kingdom and the EMS", mimeo, 1989.

Agreement on this, however, leads to two divergent policy views, with opposite political implications: the "competitive approach" versus the "institutional approach".²⁷ According to the competitive view, it is neither necessary nor desirable to go beyond some improved version of the EMS, as could be realized in stage one: it is in particular undesirable to aim at a gradual transfer of responsibilities to collective bodies. Formal coordination, in this view, is a clumsy and inefficient way to proceed: competition between national monies, allowing "the consumer of monetary services to exercise more choice and judgement"²⁸ would deliver better results at lower costs.

We can perhaps distinguish a German and a British version of the competitive view. In the German version, the opposition to any transfer of decisions to collective bodies is due to the fear that discretion and compromise would lessen the automatic discipline of the system, which is seen to rest on asymmetry.

The British version has different motivations and deeper ideological foundations, which cut across friends and foes of the EMS. The contrast as to whether and when to join the EMS is one which concerns only the choice of policy instruments for domestic targets, but not the first principles now accepted by all conservative politicians and opinion makers: it is often argued that a good reason for Britain to join the EMS and accept the first stage is to be there and prevent any further progress towards the Union. The Tories of the 80s, as Labour in the 60s and the 70s, refuse any constraint on the autonomy of domestic policies.²⁹ More importantly, the first principles represent an expression of the new conservative ideology, of which other corollaries are the refusal of tax harmonization and the opposition to any form of supranational regulations. The basic philosophy is: "let the best win", where best is what appeals most to the market. The implication of course is that other countries are expected

²⁷ The distinction is drawn by NIELS THYGESEN, *cit.*, who argues in favour of the institutional approach.

²⁸ *Ibid.* This view is forcibly argued in the U.K. Treasury paper on European Monetary Union of November 1989.

²⁹ See ALAN WALTERS, *Britain's Economic Renaissance: Margaret Thatcher's Reforms 1979-1986*, Oxford University Press, 1986, ch. 7 and, for an articulated criticism of this view, MICHAEL ARTIS, *cit.*

to accept the current British model and ideology.³⁰ Apart from this, I do not think that the arguments of the "competitive view" are particularly cogent. The issue of symmetry has in part become obsolete, or at least far less clear-cut than it used to be. As for independence of domestic policies, the British experience shows how difficult it is to achieve the status of n-th country without possessing the attributes of leadership.

The other approach envisages a gradual development of institutions, in view of establishing a framework for increasing coordination and cooperation of national monetary policies. In economic terms, this would represent a smooth transition from the present EMS to joint management. In political terms, however, this approach has important implications, as it would require a change in the Treaty of Rome (as modified by the Single Act) and in national legislation.³¹ It would thus imply a commitment to "something more", which would be set in place – no matter whether and when the dream of "one money for Europe", with its somewhat emotional and often irrational appeal, ever comes true. The approach bets on the irreversibility (or as we would say today, hysteresis) of some processes: once a step in a direction has been moved, it is difficult to turn back, or even not to move a further step in the same direction: and this is well understood by the opponents of EMU.

This, I believe, is what the current debate is about. If I can venture a forecast, I think that something will be done: it will be much less than the political enthusiasts would hope, but it will be enough to bring about some irreversible change and to alter behaviours and expectations, just as was the case with the EMS. Before or after, some economic problems will have to be faced squarely: from trade imbalances, to misaligned exchange rates, to fiscal imbalances in some countries. It would lead me astray to discuss whether a move towards EMU will make the solution easier or more difficult.

³⁰ "Britain will best serve monetary union in Europe by urging the right policies rather than embracing the wrong one" writes Sir ALAN WALTERS, *op. cit.*, pp. 130-31. Sir Alan Walters is an opponent of the EMS. But the view that competition will force other countries to conform to the standards set by Britain was forcibly expressed (for instance in an important speech at Chatham House on January 21, 1989) by the former Chancellor of the Exchequer, Mr. Nigel Lawson, a supporter of the EMS, though not of anything more ambitious than Stage One of EMU.

³¹ See NIELS THYGESEN, *cit.*

I have thus reached the end of my sketchy survey of the interplay between politics and economics in the development of, and the debate on, European monetary integration. I do not feel that I should attempt to draw conclusions. Except perhaps one. I am skeptical about the fruitfulness of an explicit interdisciplinary approach. But I am fully convinced that political factors and implications are too often neglected in the economic analysis of some phenomena – just as economic constraints and implications are too often neglected by political scientists and historians. The latter would be advised to monitor closely the current debate on European integration, as an interesting example of a mixture between economic, political, and ideological arguments. As for economists, it is their task to uncover the relevant relationships between variables by means of rigorous models. But their analysis will be all the more useful if they recognize that the quest for “the primitive object” is doomed to failure when the political feedbacks on economic regimes are strong: in such cases there is no economic model good for all seasons and each season will require its appropriate model.

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