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## The Theoretical Rationale for a Common European Currency Revisited

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THE THEORETICAL RATIONALE FOR  
A COMMON EUROPEAN CURRENCY  
REVISITED

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by

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## Introduction

At the outset of a discussion of monetary integration, the characteristics that are essential for a monetary union as well as those necessary for the continued and successful existence of the monetary union must be considered.

First, in any monetary union, either there must be a single currency, or if there are several currencies, these currencies must be fully convertible, one into another, at immutably fixed exchange rates thus effectively creating a single currency.

Second, the immutability of fixed exchange rates depends upon mutually consistent monetary policies within the union. Thus, there must be an arrangement whereby monetary policy for the union, especially regulations affecting the commercial banks' ability to create money, is determined at the union level.

Finally, there must be a single external exchange rate policy, because there can be only one rate of exchange between an external currency and the union currency. To achieve such an end, the national authorities must relinquish individual control over their international reserves and invest control in a union authority.

These three requirements - effectively a single currency, a single union monetary policy, union control of international reserves and the external exchange rate - are regarded here as essential for an arrangement to qualify as a monetary union.

It is necessary to realize from the beginning that the political commitment to achieve the goals of a European monetary system must be present. In other words, the national sovereignty member nations turn over to union authority and the extent national policies and performance

are brought into greater harmony will determine whether a monetary union stands or falls.

In economic terms, the choice between these two positions is the choice between maximizing a union welfare function or some weighted average of separate welfare functions. If the member countries are sufficiently integrated to have adopted a union welfare function for some purpose, the question of whether to centralize the relevant policy becomes largely a question of efficiency. On the other hand, if countries are maximizing their individual national welfare functions, the desirability of centralizing a policy depends, for each nation, upon the gains from cooperation compared with the cost of compromise. Obviously, no nation will be willing to become a member unless they are to be no worse off than before. The function to be maximized is thus constrained by initial welfare levels. The advantages and disadvantages for each nation of adoption of a common currency are examined below.

#### A Chronology of the European Economic Communities'

##### Attempt at Monetary Union

On March 25, 1957, the Benelux countries, France Germany, and Italy signed the Treaty of Rome and established the European Economic Community. The treaty came into force on April 1, 1958. Since 1958, Britain, Ireland, Denmark, and Greece have joined the community.

The EEC extended the common market principles of the European Coal and Steel Community by abolishing quotas on goods and services by eliminating obstacles to the movement of people and capital, and creating institutions with supranational powers.<sup>1</sup>

It was believed from the outset, to achieve the goals of the Common Market a stable monetary framework must be conceived and implemented. Articles 104-109 of the Rome Treaty authorized the formation of a Monetary Committee to monitor capital movements and exchange rate fluctuations between member states. In 1962 the Monetary Committee issued a memorandum suggesting a two-stage program by which the monetary policy of member countries would become closer aligned.<sup>2</sup> To accomplish this objective, a committee of the governors of the central banks was created to discuss and observe monetary policy of member countries. In 1964 the Committee of Governors of Central Banks was created, and it was agreed that member countries should coordinate their action in international monetary affairs.

Although intact and well-intentioned, neither the Governors of the Central Banks nor the Monetary Committee was able to forestall the string of internal monetary events that took place from 1967 to 1971. The events included:

1967, November:	Devaluation of the pound
1968, March:	Two-tier gold market
1968, May:	Events in France
1968, Fall-	Short term capital on the move,
1969, Spring:	especially from France to Germany
1969, August:	Devaluation of the French franc
1969, October:	Revaluation of the Deutsche mark
1969:	Dollar scarcity owing to high interest rates in the Euro-dollar market
1970-1971:	Reflow of short-term capital to Europe as American monetary policy became more expansive

1971, May:                               The mark and the florin float

1971, August:                            The Dollar became inconvertible

During this period of instability, two very important plans were submitted to the European Commission dealing with plans for monetary policy coordination and ultimately monetary union (linking exchange parties or a common currency). The first submitted was the Barre Plan on February 1, 1969.<sup>3</sup> The Barre Plan advocated: (a) compulsory consultation between member states whenever important short-term economic policy decisions varied from agreed-upon medium term objectives, and (b) a network of short- and medium-term financial assistance to finance balance of payments equilibrium.<sup>4</sup>

The Hague Summit in December of 1969 and the resulting Werner Group report is credited with the original plan for economic and monetary union within the Community.<sup>5</sup> The final report was submitted in October of 1970 and accepted by the Commission in March of 1971. The European Commission stated an intent to realize a common European currency by 1980. The move was fostered by a request to Central Banks to begin "narrowing the margins" between member currencies and to submit a report on the prospect for a "European Fund". As a result of the Werner Plan, the Council resolved in March of 1972 to reduce the margins between member currencies from a limit of 4.5 to 2.25% (hence, the so-called "Snake" was created) and to proceed with progressive fiscal harmonization and liberalization of capital movements.<sup>6</sup>

Considerable currency fluctuations tested the "Snake" arrangement throughout 1973, ostensibly as the result of worldwide economic instability. By the end of 1973, three members (Ireland, Italy, U.K.) were no longer participating in the arrangement. This period was also

characterized by intense pressure on the U.S. dollar. It was devalued for the second time on February 12, 1973 by 10%. As a result of the devaluation, the member countries within the EEC still participating in the Snake agreed to try to maintain the 2.25% band between their own currencies, but to allow the band to float on a "managed" basis against the dollar and other currencies.<sup>7</sup>

Since 1974 foreign exchange rates have continued to fluctuate (although in a "managed" float) in response to many diverse factors, among them: differing national inflation rates, interest rate differentials, structural shifts in the balance of payments, and outright speculation. In reality, the international monetary system since 1974 has been characterized by a confusing mixture of freely floating, managed floating, and fixed rates. In February of 1977 the International Monetary Fund reported that of the 129 countries reported upon, 34 were freely floating, 88 currencies were tied or pegged to some other currency, and seven member countries of the EEC were members of the European common margins arrangement ("snake").<sup>8</sup>

#### The European Monetary System (EMS)

On December 5, 1978, the European Council adopted a resolution based on the recommendations of the Council of Ministers and the Committee of Governors of the Central Banks which cleared the way for the entry into force of the European Monetary System.<sup>9</sup> The implementation of EMS on March 13, 1979 represents the most tangible manifestation to date of the EEC's resolve to achieve monetary union within the Community. To facilitate the process the ECU was designed as a forerunner for a European currency.

The EMS is, in reality, a complex exchange rate and intervention system combined with large credit facilities. The proponents of EMS say that it will lead to a zone of monetary stability in Europe and a greater "convergence" of financial and economic policies in participating countries. In fact, in September of 1981, the Italian government ruled that the ECU should be accepted as an official currency.

The "numeraire" for the system, the ECU (European Currency Unit), is a composite of nine common market members' currencies. It is used as the denominator for operations under both the intervention and credit mechanisms and for transactions of the European Monetary Cooperation Fund; and as a means of settlement between monetary authorities of the Community member countries. Additionally, since 1981 the ECU has accounted for the equivalent of \$1.995 billion of issues in the Eurobond market. John van Schil, deputy manager of the European investment bank, recently estimated that interbank deposits in ECU's equals between \$8.5 billion and \$13 billion.

Interest in the ECU is growing outside European central banks. An indication of this is the fact that a group of European commercial banks, a U.S. bank and various EEC agencies are formalizing a clearing system for ECU.

The ECU consists of a basket of fixed amounts of the nine currencies of the Community's members. Each currency participating in the EMS has a central rate in terms of ECU's. These central rates determine a grid of bilateral central rates, around which margins of  $\pm 2.25$  per cent have been established. The currency weights in the ECU can be observed from the table below:

Value of EC Currencies In Terms Of  
The European Currency Unit (ECU)

	<u>Old*</u>	<u>New**</u>	<u>Percentage Change</u>
Belgian/Luxembourg franc	44.9704	44.3662	+1.5
Danish krone	8.2340	8.0441	+2.5
German mark	2.3338	2.2151	+5.5
French franc	6.6139	6.7927	-2.5
Italian lire	1,350.2700	1,336.7800	-2.5
Irish pound	0.69101	0.71705	-3.5
Netherlands guilder	2.5797	2.4959	+3.5

\* Established June 14, 1982.

\*\* Established March 21, 1983.

<u>Currency</u>	<u>Absolute Currency Amounts per ECU</u>	<u>Percentage Share Individual Currencies per ECU</u>
Belgian francs	3.66	4.1
Danish kroners	0.217	2.7
German marks	0.828	37.4
French francs	1.15	16.9
Italian lire	109.0	7.9
Irish pounds	0.00759	1.1
Netherlands guilders	0.286	11.5
Luxembourg francs	0.14	4.2
British pounds	0.0885	14.1

Source: International Letter, Federal Reserve Bank of Chicago, No. 495.

The weight of the currencies in the ECU are based on the gross national product and world trade shares of European Community members.

It was decided at a meeting of the European Council in Bremen on July 6-7, 1978, that no automatic revision in the composition of the basket for the ECU would occur if there were changes in central rates within the EMS or in the exchange rates of member countries not participating in the EMS. However, the weights of the currencies will be re-examined and, if necessary, revised within six months of the entry into force of the EMS, and thereafter every five years. On request, they may also be changed if the percentage share of any currency, based on actual exchange rates, has changed by 25 percent or more.

An IMF survey of April 20, 1981 reported: Belgium, Denmark, France, Germany, Ireland, Italy, Luxembourg, and the Netherlands are participating in the EMS and maintain maximum margins of 2.25 (in the case of the Italian lira 6%) for exchange rate transactions in the official markets between their currencies and those of the other countries in this group.

It should be noted that there are a number of mechanical and technical procedures which have not been discussed above. Such measures as the "divergence indicator" (a formula to "flash" currency divergencies) and diversified intervention are beyond the intentions of this study.

What can, however, be observed from the EMS is the EEC's "firm resolve to ensure the lasting success of the EMS by policies conducive to greater stability at home and abroad for both deficit and surplus countries." Time has already proven the ECU to be the most viable exchange rate arrangement in the history of European monetary integration. The Instituto Bancario San Paolo di Torino recently showed that during the 18 months beginning in January of 1982 the ECU was the most stable currency against both the Italian lira and the German mark. The study determined the ECU to be the second most stable currency against the dollar, the pound sterling and the Belgian franc.

#### The Underpinnings of the Evolution Towards A Common European Currency

The focus of this section is on the theoretical arguments and basic motivations underlying the process towards monetary unification and a European currency. Although a full assessment of the costs and benefits of monetary integration can hardly be worked out at the current stage of the process, the arguments for monetary unification can be isolated and explained. The internal dynamics fostering the move to economic and

monetary union is the desire to reach beyond a customs union and the simple freeing of movements of goods, services, and factors of production and create among member countries conditions that will remove any bias against intra-community trade.<sup>10</sup> Underlying this move is the hope of preserving Europe as an island of stability and freeing it from the debilitating effects of shocks generated by economic systems outside the Common Market.

The rationale for the drive towards monetary unification and economic integration, however, derives as much from internal as from external Community concerns. When the Community began in 1958, its member states sold 34 percent of their total exports to other member states. That ratio had risen to 53.3 percent by 1982.<sup>11</sup> Such a shift indicates an increasing degree of intracontinental trade within the community.

Monetary integration, as prescribed in the Treaty of Rome, has always been considered as a logical and necessary step on the road to full economic union. Repeated currency crises since 1967 only shifted the emphasis from internal preoccupation towards a more externally oriented approach. Whereas internal Community building was the major driving force which inspired the proposals for monetary unification antedating the Werner report, it is Europe's position vis-a-vis the "outside" world, and the related loss of control over monetary affairs for internal stabilization purposes, which has created the major impetus in recent years.

#### The European Attempt to Recover Monetary Control

Economists from both sides of the Atlantic (e.g., Giovanni Magnifico, Robert Mundell, and Robert Triffin) agree that the most significant

advantage to forming a European Monetary Union is that Europe can regain control of its monetary policy.

Magnifico contends that the case for a common currency stems from a practical need for an international money and the unsuitability of the alternatives. Realistically, he points out that the dollar has become the dominant form of international money, and the Euro-dollar market has grown up primarily in response to the desire of those engaged in international business to hold international money.<sup>12</sup> The Euro-dollar market has offered some advantages to Europe by constituting the nearest approach to a common European money and capital market. In such a capacity it has been a potent factor favoring financial integration within Europe. However, the fundamental drawback is that by being closely linked to U.S. money markets it transmits American monetary policies to Europe.

American monetary policy is understandably implemented to achieve U.S. domestic economic objectives. Quite often, the result of U.S. policy being transmitted abroad is monetary conditions are imposed on Europe that are strongly at variance with local conjunctural needs. Magnifico asserts that, "As long as the dollar remains the international money, any European country attempting to insulate itself from American monetary policies will also insulate itself from its European partners."<sup>13</sup>

In light of cyclical factors, the size of the American economy, and the dominant role of the U.S. dollar, the monetary policy of the Federal Reserve system can convey destabilizing economic impulses worldwide. In the European case, as economies become more open they render themselves more vulnerable to the impact of American monetary policy. As the U.S. pursues discretionary monetary and fiscal policies, the rest of its

trading partners are forced to accept directly or through the Euro-dollar market the consequences of its policies. Expansionary policy usually results in a decline of U.S. market interest rates and an increase of funds to the Euro-dollar market. Such effects coupled with the real effects of an increase in American demand for imports tends to produce a worldwide inflationary impact. On the other hand, restrictive policies generally drive U.S. domestic interest rates up, attract funds from the Euro-dollar market, restrict world liquidity, and transmit recessionary effects abroad.<sup>14</sup>

Furthermore, the erosion of a currency's purchasing power makes it increasingly inefficient at carrying out its crucial function in the domestic economy. When that currency is the established international money, the same costs and distortions that inflation creates in the domestic economy appear at the world market level. In this case, however, there is an additional cost since the international currency no longer provides a stable reference point against which other countries can gauge their own domestic monetary policies.<sup>15</sup>

Little gain will be produced by replacing the dollar with a European national currency as the international money, since the country whose currency is selected will naturally conduct monetary policy with a keener eye toward domestic rather than Community conditions. "International liquidity", which in the past has been determined by the supply of dollars, would most likely be drastically reduced.

Robert Triffin elaborates further on world liquidity by suggesting that the "most significant debate concerning the evolution of an international monetary system is the inflationary proclivity of any reserve currency - convertible as well as inconvertible - enabling the

reserve currently center to finance huge and persistent deficits, internal and external, by flooding the world's reserves with its own I.O.U.'s".<sup>16</sup> Triffin points out that world reserve creation between 1973 and 1978, measured in dollars, tripled from \$191 billion to \$571 billion. The \$380 billion dollar increase was sustained at an average pace of 20% per year, much faster than any realized growth in world trade and production in real terms. The implication Triffin makes is that the U.S. was allowed - even under floating exchange rates - what de Gaulle called the "extravagant privilege" of financing most of U.S. deficits by printing more dollars.<sup>17</sup> Triffin further suggests that previous to the explosion in world reserves domestic inflationary policies were sanctioned by balance of payments deficits and reserve losses. Such a process reduced the ability of inflationary countries to avoid a devaluation, or depreciation, of their currency. Either was a traumatic experience under a fixed exchange rates, because it revealed an obvious failure of official policies and exposed responsible officials to the danger of not being reappointed or reelected to their job. In recent years, daily floating rates have significantly reduced this trauma and the consequent political deterrent to persistent inflationary policies. Although floating rates speed up the readjustment of exchange rates to competitive levels by more inflationary countries, they tend to facilitate the continued pursuit of inflationary policies by them.<sup>18</sup>

It can be concluded, then, that a primary motive for monetary integration is to set up a kind of common front against the monetary power of the United States: against "dollar imperialism". The eventual development of a common European currency will inevitably be, in part, the result of the U.S. currency achieving the status of intervention

currency, unit of account, unit of quotation, reserve asset, and an asset of settlement in international affairs. Further, the realization that when the currency of the U.S. fulfills such necessary roles, the financial institutions which use and produce it are dominant will speed the acceptance of a European alternative.

Therefore, the drive toward monetary integration should be viewed as an attempt to alleviate a situation in which Community countries have become commercially integrated with one another, but communicate mainly through the U.S. dollar.

#### The Seigniorage Issue

An inherent concern in the approach to full monetary union is the fear of a loss of national autonomy and sovereignty. Although the concept of seigniorage is difficult to quantify, there are several dimensions of gain which Europe, in fact, is familiar with. Historically, seigniorage referred to the mint charge for turning gold or silver into money. Mundell asserts that in the modern context of paper money, the term can be used to refer to the command over resources which is acquired by the authority with the monopoly over the issuance of notes.<sup>19</sup> Additionally, seigniorage gains can be identified as: the ability to finance balance of payments deficits by printing more of a currency; a less compelling need for balance of payments adjustments; reduced exchange risks for the vehicle currency residents; and the existence of denomination rents which accrue to the banking system having monopoly power over the issuance of monetary liabilities denominated in the vehicle currency.<sup>20</sup>

An incisive argument for a common European currency is that monetary institutions in the Community can recoup the seigniorage which is

presently accruing to the U.S. financial infrastructure. Thus, the seigniorage privilege, which may have slight significance in national states, acquires much greater political and economic importance when viewed in an international context. As monetary unification proceeds, and a common medium of exchange is devised, the prospect for strengthening European financial institutions and Community businesses will increase proportionately. When a common currency becomes a vehicle currency and the dollar is replaced, the benefits of a widely-based currency and the consequent diversification of services it provides will accrue to intra-European institutions.

To a degree, the ECU has begun to provide such benefits to European institutions. European Community countries other than Germany have been happy to let the ECU develop within their borders. Also, a growing amount of intra-Community trade - particularly firms dealing with French and Italian companies - is financed by ECU's. The Bank of Italy estimates that 10% of Italian foreign currency trade financing was in ECU's in 1982. Critics of monetary unification regard their monetary unit as a symbol of national sovereignty, and are apprehensive of programs which threaten that perceived sovereignty. The fear of losing national independence is probably the greatest obstacle to achieving monetary union. Such concerns emanate from the ancient tradition by which a nation's full exercise of sovereignty implies three essential activities: the administration of justice; the raising of armies; and the striking of coinage. In a world characterized by a high degree of interpenetration of economics and communication, the tradition has lost its substance and no longer conforms to reality.

The European Community has communicated mainly through dollars. The argument against monetary union due to the loss of national sovereignty is inconsistent in light of the loss of seigniorage presently being experienced by the Community.<sup>21</sup> The fragmentation of money and capital markets reduces the control of national central banks over the domestic money supply, renders its policy less powerful, and subjects nations to the vicissitudes of U.S. monetary authorities.

A common European currency would restore sovereignty to European governments as more control over their own economies is gained. Also, such a unit would facilitate a better international arrangement of instruments and policies to promote more efficient monetary management of the world economy.

#### Increased Efficiency Resulting from Simpler Transfers and Calculations

Transactions take time and a common transaction unit lowers not only the cost of search but the cost of negotiation. In the case of currencies, the greater the multiplicity of transactions a currency can perform the more economies of scale that can be exploited with a common money.

Mundell has expressed the relationship as follows:

Because of economies of scale, with respect to the use of currency, the production of services emanating from the use of a given money for transactions purposes is cheaper the larger the size of the transactions domain and the longer the common money has been used. Because memory itself is a capital asset in the production of information an increased frequency of repetition of contact slows depreciation of memory (forgetting), the cost function will tend to obey learning-by-doing laws, based simultaneously on spatial and temporal factors.<sup>22</sup>

As the EEC countries decide to irrevocably fix exchange rates between their currencies, the risks of fluctuations in the balance of payments

of each individual country is pooled. The result would be a definite economy in the foreign reserves that would be needed by the group as a whole. In addition, there will be further economies in the case of holding foreign reserves because all trade done between countries of the new currency area - which was previously considered foreign trade - will now be internalized. In addition to economizing on the amount of foreign reserves a nation needs, a common currency will provide further gains from the elimination of the transaction costs associated with the exchange of currencies.<sup>23</sup>

Other benefits from the formation of larger currency areas and a more efficient use of money would be the possibility of a reduction in exchange risks for firms caused by speculation. The benefits from reduced exchange risks have been a strong argument in favor of fixed exchange rates for some time.<sup>24</sup> The benefits of the elimination of intra-EEC exchange risks becomes greater when it is realized that the majority of trade is intra-Community and thus trade relations and payments would approximate conditions similar to those applying to movements of goods within one country. The ability to eliminate de-stabilizing speculation may well depend on the confidence of complete commitment to monetary union. If there is general confidence that an arrangement of fixed exchange rates is in place permanently, and that the political will is sufficient to maintain a viable monetary union, then the benefits from reduced exchange risks and disrupting speculation can accrue to the union.

Increased efficiency in monthly and short-run settlements between central banks and the European Monetary Cooperation Fund (EMCF) will be facilitated also with a single Community currency. The present function

of the ECU is to allow for more simplified transfers in the unit of account instead of transfers of foreign exchange. The EMCF was created by the Council of Ministers in April of 1973 with the task of promoting: (1) the progressive narrowing of the margins of fluctuations of the Community currencies against one another; (2) interventions in Community currencies on the exchange markets; and (3) settlements between central banks. Consultation and discussion on these areas should lead to a concerted policy on reserves.

Some of the desired benefits began to materialize with the entry into force of the European monetary system on March 13, 1979. Originally the EMCF served basically as a clearing agency for the "snake" operations between Community participants and as the administrator of the short-term monetary support facility. However, the EMCF was authorized to "receive monetary reserves from the monetary authorities of the member states of the Community and to issue ECU's against such assets."<sup>25</sup> The ECU issued by the EMCF is now used as one means of settlement between monetary authorities of the Community member countries and for transactions between those authorities and the EMCF.

The central banks which are participating in the exchange rate and intervention mechanism of the EMS deposit with the EMCF 20 percent of their gold holdings and 20 percent of their gross reserves in U.S. dollars against the issue of ECU's by the EMCF. The gold deposits are to be valued at the average market price of the six previous months. To the extent that change in gold and dollar values occur, central banks will make necessary adjustments to maintain deposits of at least 20 percent of these reserves with the EMCF. At the same time, the amounts of ECU's issued will be adjusted for changes in the valuation of gold or changes in exchange rates.

The short-term credit facility established in 1970 among central banks of the Community, widened to cover three adjoining members in 1973, has been maintained in the EMS. A "very short-term facility" of an unlimited amount has been established for the financing of intervention debts and claims. Such claims and interventions in EMS currencies are converted into ECU's at daily values and entered in the banks of the European Monetary Cooperative Fund. Interest on such claims is determined by the average discount rate of Community central banks.

Increased efficiency in transfers should also result from the established mechanics for the settlement of claims and debts between central banks. A debtor central bank must first use any assets it holds in the currencies of creditor central banks. However, since central banks of Community members usually hold only working balances in the currencies of other member countries, debtors have the right to settle 50 percent of their remaining debts in ECU's. The other 50 percent may be settled in ECU's only if this is acceptable to creditors.

Therefore, efficiency and, indeed, economies of scale can be realized through a common European currency such as the ECU. Community countries can benefit as their central banks and the EMCF connect their monthly and short-run settlements in a currency that will go as far as possible without being forced into exchange dealings or translation.

The private sector also stands to gain from a more stable exchange rate environment. The elimination or reduction of large parity changes will facilitate long-term planning for investment and economic growth, while minimizing the costs of destabilizing speculation.

The Elimination of Traditional Balance of Payments Problems  
Through Increased Capital Mobility

The meaning of a "deficit" or "surplus" in a balance of payments has changed dramatically since the advent of floating exchange rates. The traditional measures of a balance of payments imbalance were designed to spotlight evidence of pressure on a country's exchange rate. The pressure was measured by transactions which were forced on government "to settle" the imbalance. Such measures were known as compensatory. Thus, the "official-reserve-transactions" measure of the surplus or deficit highlights specific government transactions to fund the imbalance and protect the exchange rate from changing. An imbalance on a "net liquidity basis" is a slightly broader measure to focus attention on the same basic phenomenon.<sup>26</sup>

In a floating-rate world the traditional deficit measures no longer necessarily indicate pressure on exchange rates since the rates are fluctuating constantly. Instead, the traditional measures are significantly influenced by unusual capital movements, such as payments on oil to OPEC countries, selective government intervention in the foreign exchange markets to stabilize or change the level of exchange rates, and profit motivated investment by central banks of countries such as Saudi Arabia in foreign government securities.<sup>27</sup>

The decade of the 70's forced other realizations as well on the internal monetary system, one being that few, if any, of the world's trading partners are willing to tailor domestic stabilization policies to the demands of balance of payments problems, i.e., external balance. Japan, Germany, and the U.S. have pursued domestic policy goals that often have been inconsistent with balance-of-payments equilibrium. A

widely held view is that Japan and Germany have been able to maintain a balance of payments surplus as the result of continuous internal policies which have avoided excessive increases in money supply and the rate of inflation. By extension, the conclusion is reached that the U.S. balance of payments deficit has been attributable to excessive increases in the money supply and the rate of inflation. It is only very recently that a strong U.S. dollar has been responsible for American trade deficits.

The above situation helps to focus upon how increased capital mobility and centralization of the control of the EEC's money supply can reduce balance of payments problems, and exchange rate tension between Community members when a common currency is operational. The benefits to accrue to the Community reflect the theory inherent in the optimum currency area literature. According to Mundell, the definition of such an area hinges upon factor mobility.<sup>28</sup> Mundell asserts that the optimum domain of a monetary union exists when there is full mobility of factors of production between the regions it comprises; in this way, international factor movements can substitute for changes in regional exchange rates. McKinnon and Kenan refer, on the other hand, to elements of economic structure. McKinnon classifies, for analytical purposes, the goods produced by a country into tradable and non-tradable goods. He argues that: "The optimal currency arrangements may be to peg the domestic currency to the body of non-tradable goods (i.e., goods produced domestically, and imported) and change the domestic prices of tradable goods (i.e., good produced domestically, and exported) by altering the exchange rates to improve the trade balance."<sup>29</sup>

While McKinnon stresses the degree of economic openness, Kenan emphasizes diversification. "...diversity is a nation's product-mix, the number of single product regions contained in a single country may be more relevant than labor mobility..., a well diversified national economy will not have to undergo changes in its terms of trade as often as a single-product national economy."<sup>30</sup>

Regardless of how such an area is optimally defined, with regard to the European Community, the balance of payments problem would become regional rather than national. Since exchange rate changes would be ruled out, and no barriers would exist for capital mobility, other measures would be used to correct intra-Community imbalance. Such measures, as James Meade's model suggests, must focus on the two main performance criteria of internal and external balance.<sup>31</sup> Internal balance refers to some combination of full employment and price stability, while external balance is considered to be an equilibrium in the balance of the payments. Generally, authorities have at their disposal either expenditure increasing or decreasing policies (monetary and fiscal policy), or expenditure switching measures which include exchange rate variations, trade and capital restrictions, as well as exchange controls. In this context, a commitment to fixed exchange rates would mean the loss of a policy instrument. However, with the advent of a common currency such as the ECU, and the operation of EFMC as a central bank, monetary policies would be coordinated in such a way to achieve internal priorities throughout the Community "region". Such monetary harmonization would ultimately lead to greater fiscal policy consultation between community members to remedy problems of less competitive regions. This implies that fiscal policy may become the single most important policy instrument at a nation's disposal.

To facilitate the harmonization mentioned above, the EMS contains both a Short-Term Monetary Support facility (STMS) and a Medium-Term Financial Assistance facility (MTFA). The STMS provides for credits to the central banks of Community members for the financing of temporary balance of payments deficits. Credits are granted without economic policy conditions, but they trigger subsequent consultations. Credits have a duration of three months originally with the possibility of renewal for another three months. The STMS is available to all member countries, and each has a "debtor quota" (borrowing ceiling) and a "creditor quota" (commitment ceiling), the latter being twice as high as the former to safeguard the viability of the system under varying distributions of payments imbalances among member countries.<sup>32</sup>

The MTFA facility provides credits to any member country in "difficulties or seriously threatened with difficulties as regards to its balance of payments." Credits under this program will be extended for two to five years and will be subject to economic policy conditions to be laid down by the Council of Ministers. In formulating conditions and monitoring the performance of a debtor country, important advisory roles are assigned to the European Commission and the Community's Monetary Committee. The MTFA has creditor ceilings but no debtor ceilings for member countries, and provides for "refinancing from outside the system if necessary by concerted action of member states with other international organizations."<sup>33</sup>

Therefore, in theory and in practice the European Community countries can benefit from the reduced balance of payments tensions as the goal of a common European currency becomes a reality. The resolution which established the EMS states the intention "to ensure the

lasting success of the EMS through policies conducive to greater stability at home and abroad for both deficit and surplus countries."<sup>34</sup> Furthermore, a strong emphasis has been placed on the convergence of economic policies to achieve both equity and economic growth. Steps must be taken to strengthen the economic base of less prosperous countries of the community due to the national loss of some control over their own economy. Indeed, such a long-term commitment to stability will benefit the European Community as well as the international monetary system.

#### Conclusion and Thoughts On the Future

Edmund Burke, one of Europe's most perceptive author-statesmen, made the statement: "All government, indeed every human benefit and enjoyment, every virtue and every prudent act is founded on compromise and barter." If such a concept is heeded by the participants of the European Monetary System, then the Common Market countries may well be on their way to the much-heralded Monetary Union. Europe stands at a crossroads - politically, of course - but also at a crossroads to decide the future of the European Monetary System. To some extent the dollar standard lies behind. To the left and right, national currency areas exist with flexible exchange rates. Ahead, lies the path to a common currency and economic and monetary solidarity among the European Community countries.

For more than three decades Europe has huddled for relief under the umbrella of a friendly America. The dollar has served as a vehicle

currency for European integration - an anchor. If this system returns it will perpetuate a growing U.S. balance of payments deficit, increasingly undermine the European drive for monetary independence, diminish her economic power, and most likely return America to an era of protectionism and controls. What is necessary, above all, is a transformation of attitudes in Europe: a shift away from the concept of a competitive national interest and rivalry; a shift away from the idea that there is time to spare, and that integration will still be possible two or three decades from now. A political will and consciousness must demonstrate that European independence is worth saving. The current costs from lost sovereignty, reduced monetary control and complex currency transactions are more than the cost of some lost national independence.

If political cooperation can be achieved, and the rising costs of monetary dependence recognized, the European Monetary System has a good chance of survival. This is not because it is a flawless system, or because its participants all attach the same significance to monetary discipline, but because such a large percentage of each country's trade is with fellow members of the EEC. Their common interest demands reasonable stable exchange rates. It seems appropriate then to ask, "Since exchange rates are being managed anyway, why shouldn't EEC countries manage them together?"

Currently the ECU is the linchpin of the European Monetary System. The development of the role of the ECU has reached a stage where there is a need for information and careful analysis of the present situation. The swift growth of ECU deposits and the nearly \$2 billion in ECU denominated bond issues makes such discussions imperative if the momentum is to be sustained.

Recently, Yves Le Portz, President of the European Investment Bank, reported on the growing use of ECU's in what he termed the "private ECU circuit". He stated that almost the entire range of banking services can be offered in ECU's. The services include: (1) accepting deposits in ECU's; (2) granting loans for various terms (3) financing foreign trade in ECU's; and (4) even the option of ECU denominated savings accounts exists.

As the ECU has become an instrument of settlement and saving, the private sector has begun to recognize and accept the ECU as a currency. As the money and capital markets continue utilizing the ECU the advantages of a common unit of exchange will be substantiated.

The next step is to remove exchange controls that prevent Community resident and institutional investors from investing in ECU denominated bonds. Such action will undoubtedly lead to greater political acceptance of the ECU and enhance the prospects for a truly common European currency.

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