FRBSF Weekly Letter

August 10, 1990

European Financial Integration and Monetary Policy

The "Single European Act," adopted by the European Community (EC) in 1986, calls for eliminating all remaining trade and capital restrictions among the twelve member states by 1992. Increased integration of goods and financial markets in Europe will have major implications for the conduct of national monetary policies in the region.

Currently, the central banks of most countries in the EC coordinate their policies through the European Monetary System (EMS), a regime intended to maintain stable exchange rates among member countries. Most observers agree that with increased integration, however, the disruptive effects of divergent policies will be heightened, and as a result, even greater coordination of economic policies will be necessary after 1992.

What form this coordination will take and the extent to which individual countries will lose national policy sovereignty is unclear. One proposal policymakers in the EC are considering calls for eventual economic and monetary union through the creation of a European central bank and adoption of a common currency. This *Letter* reviews the current institutional arrangements and discusses issues related to economic policy coordination in Europe.

Current monetary arrangements

The European Monetary System (EMS) was established in 1979 to maintain stable exchange rates among participating countries. A central feature of the EMS was the creation of a monetary unit of account among member countries, called the European Currency Unit (ECU); it was a weighted average of the currencies of the nine members of the EC at the time (West Germany, France, Italy, Belgium, the Netherlands, Luxembourg, the United Kingdom, Ireland, and Denmark). The EMS also created an exchange rate mechanism (ERM), which provided for each member's currency to fluctuate no more than plus or minus 2¼ percent relative to the values of the other EC currencies. (Italy's currency was allowed to fluctuate plus or minus six percent. Moreover, the U.K. did not join the ERM, but the pound was included in the ECU on the assumption that the U.K. would join later.) Finally, the EMS established a European Monetary Fund (EMF) to provide short-term and medium-term balance of payments assistance.

The ERM generally has been regarded as successful; exchange rates have been relatively stable, and inflation has fallen from an average of 8.7 percent in 1979 to 2.5 percent in 1988. However, the ERM has not been without problems. Despite the overall reduction in inflation within Europe, in France and Italy inflation still is generally higher than that in West Germany. As a result, these "weak currency" countries have needed to resort to periodic exchange rate realignments to offset declining competitiveness. In addition, they have had to impose international capital controls to dampen the speculative rises in domestic interest rates associated with investors anticipating these realignments.

Since the success of the ERM has depended in part on the existence of capital controls, the removal of these controls as financial liberalization proceeds will place added strains on existing monetary arrangements. To maintain ERM exchange rates, then, financial liberalization will necessitate greater convergence of money growth and inflation rates among EC member countries. In fact, many of the smaller countries of the EC implicitly have recognized this already by choosing to follow the monetary policy lead of West Germany and keeping their exchange rates in line with the Deutsche mark (DM).

Nevertheless, most question whether monetary coordination will be effective under such a loose arrangement once all barriers to intra-EC capital movements are removed. Consequently, many are calling for more formal arrangements that would allow for closer coordination of policies.

The Delors proposals

To provide a basis for discussion regarding needed changes in current monetary arrangements and institutions within Europe, the EC issued a report in April 1989 called the "Delors Report," after the President of the European Commission and the chairman of the committee that prepared the document. The Delors Report proposes a three-stage process designed to create a complete economic and monetary union (EMU) within the current twelve-nation EC, which now comprises the nine original members, plus Greece, Portugal, and Spain. The first stage of the process would commit all EC members to closer economic policy coordination generally, and to participation in the ERM specifically (including the U.K., which has heretofore not participated). The Report, however, does not establish a deadline for this stage.

The second stage would establish a European System of Central Banks (ESCB), reminiscent of the U.S. Federal Reserve System and therefore dubbed the "Eurofed." This stage also would require the Council of Finance Ministers to set nonbinding rules for national budgets and the way those budgets are financed. In this stage realignments of exchange rates would be permissible, but only as a last resort. The ESCB would begin the transition from an environment in which member countries attempt to coordinate essentially independent national monetary policies to an environment in which members formulate a community-wide monetary policy.

In the final stage, the Delors Report envisions permanently fixed exchange rates, with sole control of monetary policy granted to the ESCB. It is in this final stage that change-over to a single European currency would take place. In addition, rules established by the Council of Finance Ministers concerning budgetary policies would become binding. Again, the Report does not recommend a specific timetable for this stage.

At this time, policymakers have agreed on general guidelines for the implementation of the first stage of the Delors Report, although the U.K. still resists joining the ERM because of unwillingness to give up monetary policy control. The discussion now has shifted to the specifics and timing of the second and third stages in the move towards monetary union. Two major issues must be addressed: the nature of the proposed "Eurofed" and the possible need for coordination of European fiscal policies.

Eurofed

With respect to the Eurofed, policymakers have been debating the extent of this institution's accountability and independence. Most EC countries agree that the best way to maintain an anti-inflationary monetary policy would be to make the Eurofed independent of national and EC authorities, including finance officials. West Germany, in particular, contends that price stability depends largely on the ESCB remaining substantially independent of political control. France and the U.K., on the other hand, prefer that national finance ministers maintain responsibility for exchange rate policy and currency intervention.

As a compromise, in March 1990, policymakers agreed that the ESCB will have responsibility for conducting monetary policy. The European Council of Finance Ministers will set broad exchange rate and currency intervention policy, with the ESCB responsible for conducting day-to-day management. The ESCB will be governed by the governors of the national central banks and special appointees of the national governments.

Under this arrangement, the independence of the new Eurofed will depend in large part on the extent to which the national central banks are independent of their respective national governments. Currently, only the Bundesbank of West Germany and the Netherlands Bank have particularly strong reputations for policy independence. Many of the other central banks tend to follow the leads of their own governments.

Fiscal policy

The second major issue related to the establishment of a European monetary union is the extent to which the fiscal policies of the EC member countries will need to be aligned to allow smooth coordination of monetary policies and to maintain exchange rate stability.

Some have argued that fiscal convergence among the member states of the EC is desirable, and perhaps even necessary, if the monetary union is to be successful. According to this view, the reduction in monetary autonomy of national central banks required for monetary union will in many cases limit the extent to which budget deficits can be financed via inflationary money finance. Consequently, those countries currently with high debt burdens will need to reduce their fiscal deficits to preserve the credibility of their commitment to stable exchange rates.

For this reason, the Delors Report suggested that binding rules eventually would be needed to limit the size of budget deficits in individual EC countries, as well as the extent to which those deficits could be financed through monetary expansion. In fact, the monetary authorities of a number of countries, including Italy, Belgium, and the Netherlands, have expressed doubts about the ability of national fiscal authorities to curb spending sufficiently, and so, would prefer to establish formal limits on *spending* as well as on fiscal deficits. Germany also supports this position, arguing that without such limits, European interest rates could be pushed up by excessive spending elsewhere in the Community.

An alternative view is that financial liberalization will force fiscal policies to converge, without any need for formal limits on spending or deficits. According to this view, as EC governments seek to finance budget deficits in the open market, they will face risk premiums that reflect the market's assessment of the difficulty each country will experience in servicing its debt, in much the same way that states in the U.S. do now. These risk premiums will provide an incentive to both public and private borrowers not to overextend spending. Opponents of this view, however, question whether the market will be as effective in curtailing excessive government spending as it is in disciplining private borrowing.

In recent EC meetings, policymakers adopted a compromise that would allow members of the proposed economic and monetary union to set their own budgets, but would require them to submit their budgets to the European Council of Finance Ministers for approval, with the understanding that only the most profligate countries could be requested to make cuts. If this sort of peer pressure were to fail to bring about the desired fiscal restraint, a series of sanctions would be considered, including withholding EC funds and even suspending EMU membership. As in the case of monetary policy, the U.K. remains the odd man out, refusing to accept the possibility of compulsory spending cuts.

A difficult tradeoff

Achieving the multiple objectives of free trade, perfect capital mobility, and fixed exchange rates among EC members requires an accompanying loss of national monetary, and possibly fiscal, policy autonomy. Much of the current debate in the EC centers on how much national policy sovereignty must be ceded to make the proposed monetary union workable. National self interest dictates that individual countries will still want to retain some control over their domestic policies. Without political union, then, an independent European central bank along the lines of the Federal Reserve may not be feasible.

Nevertheless, the EC has made considerable progress towards the establishment of a common monetary authority, which at the very least, can facilitate monetary policy coordination among the member states. Better coordination will foster price and exchange rate stability. From this foundation, EC members will be able to determine what further institutional changes need to be made to permit the formulation of a common monetary policy.

Reuven Glick
Research Officer

MONETARY POLICY OBJECTIVES FOR 1990

On July 18, Federal Reserve Board Chairman Alan Greenspan presented a mid-year report to the Congress on the Federal Reserve's monetary policy objectives for the remainder of 1990. The report reviews economic and financial developments in 1990 and presents the economic outlook heading into 1991. For single or multiple copies of the report, write to the Public Information Department, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco, CA 94120, or phone (415) 974-2246.

Editorial comments may be addressed to the editor (Barbara Bennett) or to the author. . . . Free copies of Federal Reserve publications can be obtained from the Public Information Department, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 974-2246.

Research Department

Federal Reserve
Bank of
San Francisco

P.O. Box 7702
San Francisco, CA 94120

Address Correction Requested