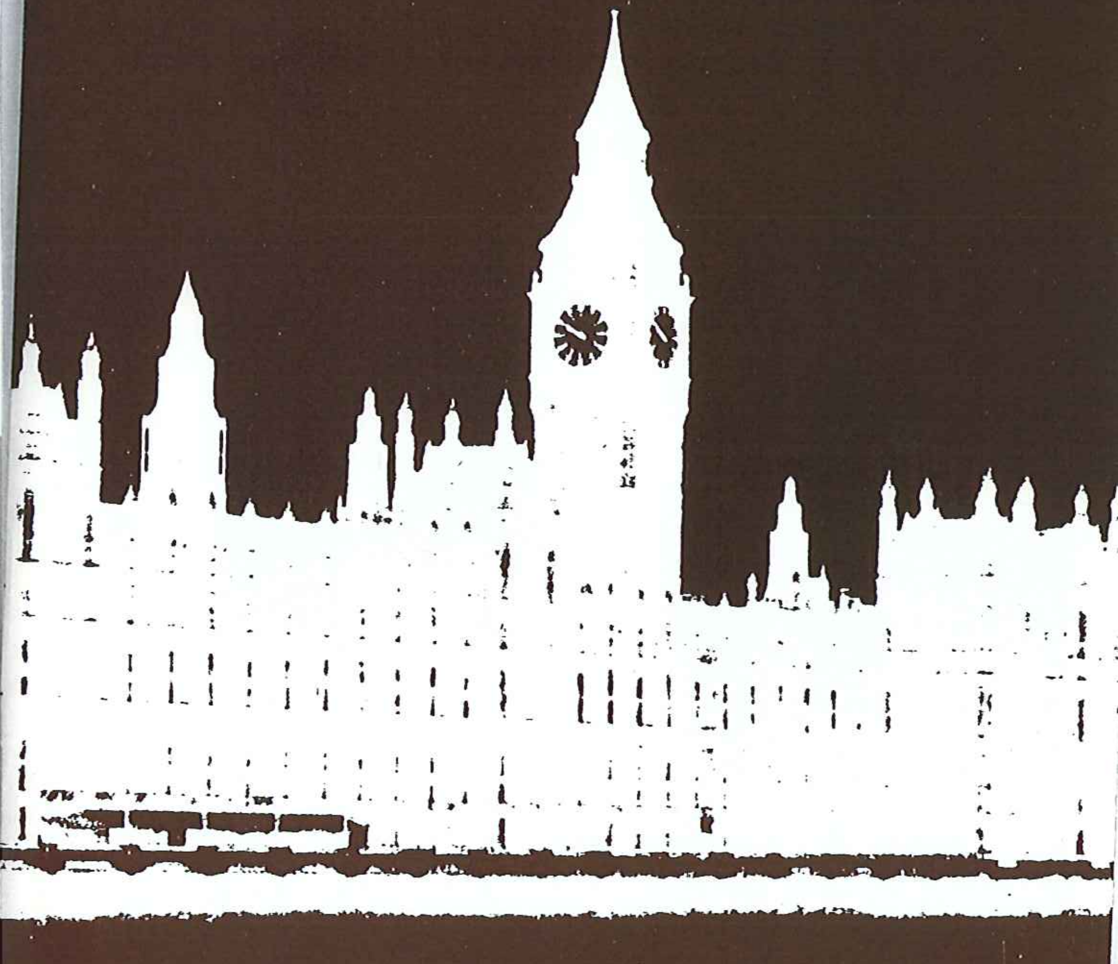
Policy Study No 121

A cautionary tale of EMU

Some mistakes, some remedies

Andrew Tyrie



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8 Wilfred Street, London SW1E 6PL

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The author

Andrew Tyrie was special adviser to John Major and, before him, to Nigel Lawson at the Treasury from 1986-1990. He is now a Fellow of Nuffield College, Oxford. He is the prospective Conservative candidate for Houghton and Washington.

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Introduction

Economic and monetary union (EMU) has become a central issue in West European politics today[1]. EMU is a linchpin of French foreign and economic policy. Helmut Kohl appears to consider that an EMU treaty, taken together with steps towards European political union, would be his crowning achievement as German Chancellor, sitting alongside the unification of his country. In Britain, the EMU issue has contributed to the downfall of the three most senior and influential figures in British politics in the 1980s: Margaret Thatcher, Nigel Lawson, and Sir Geoffrey Howe.

Why has EMU assumed such a central role in European politics? What are the economic benefits of EMU and do they justify the price in terms of loss of control over our own affairs and/or sovereignty?

The first three chapters of this paper offer some answers to these questions. The first chapter explains how EMU has come to play such an important role in the politics of Europe. Without first understanding the politics of EMU it is not possible clearly to understand the economics.

The second chapter examines the view, strongly argued by some in Britain, and elsewhere in the Community, that EMU would fundamentally alter Member States' sense of national identity, and involve an irrevocable loss of sovereignty.

The third chapter examines the economic benefits said to result from EMU.

The conclusion makes some suggestions for British policy towards EMU, in the light of these chapters.

1
The politics of monetary union

Origins of the present debate

The renewed interest in monetary union can be explained largely in terms of the politics of the Franco-German alliance.

France

Much of France's interest in EMU derives from many people's belief that it might bolster the Franco-German Alliance, the principal means by which France retains a disproportionate influence in Europe. France's position needs bolstering for several reasons.

First, Germany's increasing economic dominance, combined with her growing maturity, has gradually exposed the myth of equal partnership in the Franco-German alliance. Second, the decline of the threat from the Soviet Union, combined with the acceleration of *détente*, provided the opportunity for Germany to look eastwards as well as westwards in her search for security. The long shadow of Rapallo has haunted French foreign policy for decades; it is there once more. Third, partly as a consequence of her greater self-confidence, Germany sought to deepen her alliances with other Western countries. She found, prior to the Gulf war, a more sympathetic ear in Washington. She might also have succeeded with Britain, were it not for periodic rebuffs, made more serious by the difficult relations between Helmut Kohl and Margaret Thatcher.

All this was happening even before the unification of Germany. Unification intensified the process. The fear of a larger Germany heightened French awareness of their own declining influence. The collapse of the Soviet empire in Eastern Europe greatly strengthened Germany's hand in her relations with the Soviet Union[2]. US foreign policy objectives in Europe increasingly coincided with Germany's attempts to broaden the base of her West European relationships[3].

Faced with these developments the French anxiously sought out other means of retaining their disproportionate power, derived largely from their singular influence over Germany, and (partly through Germany) over the direction of the European Community. EMU is one such means.

Many in the French political and bureaucratic establishment see

EMU as one of France's last opportunities to tether Germany to a wider and West European framework, one which she has helped so much to shape. The French would rather see the EC develop as a major international player than find themselves excluded entirely from a group of three consisting of the US, Japan and Germany. So a central French objective has been to obtain German signature to a grand European Treaty. They would see it as a kind of insurance certificate. If the Germans were, at some subsequent stage, to resile from part of it the French would then hope to exercise some influence on the direction of policy by pointing to the Germans' 'un-European' behaviour.

The *Tresor* is, perhaps, less persuaded by the political arguments but sees EMU as a means for weakening the power of the Bundesbank. Their dislike of the deutschmark zone, that omnipresent symbol of German economic ascendancy, is patent.

Some in France also hope that the call of wider European demands might do something to sap the German sense of national identity, enabling it to be subsumed in a wider European framework. However, others in France, at least on the Right, have also expressed concern that Europe, and particularly EMU, might weaken their own identity.

The desire of the French to obtain German signature to an EMU treaty has been further reinforced by the near collapse of many other aspects of French foreign policy.[4]

Germany

French pressure alone would not have sufficed to propel EMU towards the top of the Franco-German and hence the European agenda. Notwithstanding the Germans' attempts to broaden their support by wooing Washington, Germany still needs France. German political self-confidence has not grown to match her economic self-confidence[5]. The Gulf crisis is a reminder of the limited capacity of Germany's economic success to substitute for a willingness to exercise military power. She remains vulnerable to the charge of recidivism, to the lingering memories of the last war, and to the absence of any clear psychological or territorial limit to the sense of German identity.

That vulnerability might one day be translated into practical terms. The Franco-German relationship was a cornerstone on which the return of the Germans to the international community and respectability was built. Were a French President ever to accuse a German Chancellor of being un-European or of having repudiated a major European commitment, the effects on German politics could be considerable. Whereas such an attack on a British Prime Minister might easily result in a strengthening of support for his or her Government, in Germany it could just as easily weaken a Chancellor's domestic political base, particularly given the exigencies of German coalition politics. It is often said that the Germans cannot do without the French in their international relations. It is almost as true that German politicians cannot do without the French in their domestic politics.

Unification, at least for the time being, has intensified this need. Much German public opinion (and most of the leadership) is as anxious to find a European solution to the 'German problem' as are the French. A pro-European strand is also strong in Christian Democratic thinking and owes much to Adenauer.

This goes a long way to explaining how it can be that the Germans appear to neglect their own economic interests. Certainly, from the German point of view the economic arguments in favour of currency union are not strong. The Bundesbank already exercises most of the monetary control which the Germans could wish for under Stage I of Delors.[6]

The Bundesbank itself naturally sees EMU as a threat to its existence. But its wishes may come to be subordinated to those of the *Bundeskanzleramt*. Already, the Bundesbank has been overridden once, on the question of German monetary union. Nonetheless, the draft statutes prepared by the central bank governors appear to lean towards the Bundesbank model. This may, of course, merely reflect the influence of Karl Otto Pöhl and the fact that the report was prepared by central bankers.

The acid test of how far the Bundesbank is overridden on EMU will be the extent to which the constitution of any new European institution accords 'Bundesbank-type' independence to it[7]. By contrast, the French have been pressing for greater 'accountability' for any new European monetary institution. The more directly that institution is open to influence by politicians, the less satisfied will the Bundesbank be with it.

For the French, obtaining 'accountability' is crucial to their negotiating position; it is the most effective way to erode what they see as the dominance of the Bundesbank in French monetary and economic affairs.

Other pressures for EMU

So far, I have argued that the EMU debate has been driven almost entirely by politics and in particular by the tensions of the Franco-German alliance. Of course other developments have played a part.

First, the relative success of the EMS, assisted by a sustained period of steady growth in the mid and late '80s, has strengthened the view that further monetary integration could yield economic gains. Second, the acceleration of economic integration as a consequence of the Single European Act can be said to imply, in economic terms, the need for further progress in the field of monetary integration.

Third, not only France but Italy, Belgium, Holland and others, support EMU, partly as a way to curtail the power of the Bundesbank. The Italians also see EMU as a way to obtain a toe-hold in the Franco-German axis. And several of the poorer, smaller countries look at EMU with an eye to obtaining increased regional assistance.

There is force in these points, but none of them is enough to explain the acceleration of pressure for monetary union. The origins of that pressure lie in politics, not economics[8]. Only the exigencies of the Franco-German alliance can fully explain why it is that Germany should want to abandon an arrangement as favourable to them as the ERM[9], why it is that the French seem to be obsessed with the need for 'accountability' in EMU, and why it is that German unification, far from leading to calls for slower progress to EMU (as much economic logic would suggest) has if anything led to calls for faster progress. De Gaulle is alleged to have said: 'The European Community is a coach and horses; Germany is the coach and horses and France is the coachman'. EMU is about a struggle to take hold of the reins.

The central role of the Franco-German Alliance also explains the apparent marginalisation of Britain (and, indeed, other Members of the Community). Historically, the British have primarily seen the European Community as a means of securing economic rather than political objectives. Pragmatism has been the hallmark of British policy. The British have sought to examine the economic benefits of EMU and have been less than altogether convinced. Against that, many have argued that there is a high political price: the transfer of control over their own affairs partly at the behest of a European institution which has had, at best, only a mixed record in delivering the policies for which it is responsible. Both these allegations, about the loss of sovereignty as a consequence of EMU and about its economic benefits, will now be examined.

2
Sovereignty and monetary union

It is clear that the creation of a single currency would require the handing over to a central European authority of a large number of functions at present exercised by the Bank of England, often under the supervision of the Treasury[10]. This undoubtedly represents a reduction in British control over its own affairs, but by no means necessarily constitutes a shedding of sovereignty[11].

Those in Britain who have argued on sovereignty grounds against any commitment to a Treaty providing the option of a single currency have greatly overstated their case.

What follows is no more than a somewhat formalised recital of what many instinctively feel, that the first call of people's loyalties in Europe, and particularly in Britain, will remain with Nation States for the foreseeable future. Such fundamental loyalties would not be transferred to Brussels by a treaty on monetary union. The ultimate sovereign power of their legislatures, or whatever other constitutional arrangements exist for expressing that power, would not be affected.

Sovereignty

Two essential characteristics of sovereignty would seem to be, first, the right to limit or relinquish control over one's own affairs; second, the right to claw back that control.[12].

The principle that control over one's own affairs may be eroded by treaty is as old as international relations. Two contemporary examples are signature to the Charter of the European Court of Human Rights and signature to the Treaty of Rome[13]. No new constitutional principle would seem to be established by the further transfer of responsibility for monetary policy, provided first that it was the free decision of the sovereign power (in Britain's case, Parliament) and second that the sovereign power retained the right to reassert its control should it wish, *in extremis*, to do so.

Certainly, such a transfer might entail the loss of accountability of the executive to the Westminster Parliament. It is worth bearing in mind, however, that Parliament has never had a direct responsibility for the creation of money nor for the operation of monetary policy[14]. Both the Bretton Woods system and the system of floating rates have been matters for executive or prerogative control. In 1946 nationalisation put the Bank of England firmly in the hands of the executive, not of Parliament. Nor has Parliament ever had a direct role in controlling the level of borrowing.

Parliament's essential 'sovereign power' consists of the requirement for annual legislative authorisation for taxation and of the supply estimates, 'the power of the purse'. This power would probably be unaffected by signature to a monetary union. Indeed, it can be argued that Parliamentary sovereignty has been made vulnerable to a far greater extent by the growth of the Community budget, and by the growth of competence in the field of indirect taxation, than it would be by monetary union[15]. But also it could controversially be argued that monetary union would be bound to entail a much greater degree of direct involvement in revenue raising matters by the European Community, in which case there would be further erosion of Parliamentary authority over the 'power of the purse'.

Nonetheless, by far the clearest test of whether sovereignty has been handed over would be the capacity of Parliament to exercise its sovereignty by repealing any EMU legislation, and if necessary by repealing the European Communities Act itself.

The economic price of withdrawal from a possible EMU is of course, hard to estimate but could well be considerable. If it were held that such withdrawal would also require leaving the Community (which is impossible to conclude at this distance), then the price could be enormous. The technical task might also be substantial and it would be foolish to belittle it. Difficulties would be likely to grow, the longer the single currency was in place. (Those who believe that withdrawal from an EMU would be *impossible* on technical grounds are urged to turn to Appendix I, which examines the likely problems.)

Nevertheless if the Parliamentary and political will existed to bring back sterling, it could and would be done[16].

Moreover, monetary unions have come and gone over the years. These have included the Latin monetary union of 1865 between France, Italy, Belgium and Switzerland, the Germanic monetary union of 1857 between Austria and members of the *Zollverein*, and the Scandinavian monetary union of 1873. The most famous union, the gold standard, operated between all the major industrial powers between 1876 and 1913. Since the Second World War monetary systems falling short of union came and went, including Bretton

Woods and the 'snake'. The creation of the EMS led to the withdrawal of the Irish punt from union with sterling.[17]

If the analysis above is correct it is wrong to suggest, as some have done, that Britain would somehow cease to be a sovereign state by entering into a treaty bringing about monetary union[18]. There may, indeed, be a high price attached to joining a monetary union, but it is not the price of loss of sovereignty. It is the largely economic price of making a mistake and subsequently having to disentangle oneself from it.

One further implication of the weakness of the sovereignty argument is that those who hope that EMU might somehow subsume 'the German problem' in a wider European identity are also probably mistaken. Even after monetary union if, at some subsequent stage, Germany or France decided that its supreme national interests conflicted with participation that country could withdraw, and recreate its own currency. That would be a dramatic step and could entail a high economic and political price. But the option would remain.

Loss of control

This chapter has, so far, addressed the question of whether EMU would result in a loss of sovereignty. There is, of course, the much wider question of the degree to which membership of an EMU would result in a loss of control of member country's affairs, and whether such loss of control is acceptable.

Clearly, the loss of control involved in an EMU could be considerable. Not only would the direct control of the issue and regulation of money would be lost, it is quite possible that EMU could lead to greater Community involvement in fiscal policy and economic regulation. Furthermore, several countries, particularly Germany and Italy, would like a strong political dimension as a counterpart to EMU, involving the extension of majority voting in the Council, the incorporation of the federal principle of subsidiarity into the Treaty[19], and the extension of the Community's role in foreign policy and security matters, amongst much else. Such a package would certainly erode a country's control over its own affairs.

Furthermore the direct loss of control implied by EMU would be accompanied by an end to the traditional methods of accountability. Much of the confused discussion about loss of sovereignty has been fuelled by some people's instinctive dislike of the idea that a body dominated by 'foreigners', on long term contracts and largely independent of Parliamentary scrutiny, should set British interest rates. Chancellors may make mistakes when they exercise their power to set interest rates; but at least, the argument runs, they are members of elected governments accountable to Parliament.

There may a good deal to these arguments. Nonetheless, their proponents should bear in mind that the 'independence' which Britain has enjoyed in recent years in setting interest rates might have been to some extent illusory. The authorities have, of course, been able to set short-term interest rates. However, it is arguable that, beyond the short run, many of the 'powers', if Britain ever had them, have been largely surrendered to the markets and to foreign economic policy makers years ago. Furthermore, whatever genuine independence Britain has enjoyed in recent years has now been further eroded by membership of the Exchange Rate Mechanism of the EMS[20]. Nor is it clear that such independence has delivered better economic decisions. It should be small comfort to argue that at least the mistakes were homegrown.

Those who argue against any change to present arrangements for the scrutiny of Chancellorial decisions on interest rates are also thereby ruling out reforms for giving greater independence to the Bank of England. For any increase in the Bank's independence could not possibly be held to erode control by the British over their own affairs. Yet it is notable that virulent opponents of EMU often also oppose the suggestions recently made for greater Bank independence.

These three questions, the extent to which independence has been enjoyed in the past (and is still enjoyed), the extent to which such independence has been beneficial, and the related question of the independence of the Bank of England, are all very controversial. This chapter does not draw conclusions on them. The limited conclusion is only that EMU would entail some loss of control over a country's own affairs but that this would almost certainly not entail a loss of sovereignty. The 'worst case' price of joining EMU is the largely economic price that renegotiation or withdrawal might entail. Set against that are the economic benefits which might flow from monetary union, which the next chapter addresses.

3
The economics of monetary union

Most economists agree about the economic benefits of monetary union. They are simply stated: the elimination of exchange rate uncertainty, the reduction in transactions costs, and all the benefits which flow from these.

However, in deciding whether to go ahead with the prescriptions of the Delors report the benefits of a single currency must be compared with those of the high degree of monetary integration already obtainable with narrow bands in the EMS, the so-called Stage 1. By far the most comprehensive, not say exhaustive, case for these extra benefits has been made by the Commission itself in a series of papers[21].

Summarising, the benefits are said to include:

- greater price stability
- the elimination of exchange rate uncertainty
- benefits to public policy and the public finances
- benefits to the international economic system.

One cost is held to be that regional imbalances could be exacerbated, largely from the loss of power to devalue.

Price stability

If one could be sure that monetary union would cure inflation there would be no need to rehearse any other arguments in its favour. That alone would suffice. But there *is* no necessary connection between the creation of a single currency and the achievement of price stability. On the contrary, it is at least arguable that a Delors-type Stage III would be less likely to deliver price stability than a Stage I-type system dominated by the Bundesbank. As a recent paper by HM Treasury made clear, it is very plausible that a Stage III-type system could lead to convergence of inflation performance around the average rather than the best[22].

It is natural that countries should like to have more influence over the Bundesbank. And it is reasonable to suppose that those countries whose governments have rarely shown the necessary will to fight inflation domestically might be better served by a Europe-wide institutional framework. But, as far as the goal of price stability is concerned, it does seem that they might do better to stick to the Bundesbank's coat tails than to flirt with an untried European experiment.

There is also another line of argument to suggest that monetary union might lead to greater price stability. Some people, while sceptical about the effectiveness of any European institution, nevertheless see the debate about monetary union as a means by which greater independence may be accorded to their domestic central banks. The greater the independence generated, it is argued, the better will be the delivery of an anti-inflationary performance.

There may be a good deal in this. Several central bank governors in Europe have also pointed to the fact that, even under any form of Stage 11, greater independence for central banks would be required.

Nonetheless, independent central banks are certainly not the cure for all monetary ills. They are neither a necessary nor a sufficient condition for good anti-inflation performance. Evidence of the former is that Japan, for example, has in the 1980s succeeded in delivering low inflation without an independent central bank. Evidence of the latter is the US, where the substantial independence of the Federal Reserve has delivered a mixed record on inflation.

In sum, European monetary constructs might be able to deliver better anti-inflation performance. On the other hand they might not! Much would depend on the structure of the institution, and the manner in which its directors were made accountable to their respective governments. Anti-inflation performance would also depend, of course, on all those cultural and behavioural factors which have made inflation so difficult to eradicate in inflation-prone economies for decades.

Exchange Rate uncertainty

There are two main ways in which variable exchange rates might incur economic costs. First, it is clear that the existence of separate national currencies increases the risk of any transaction by generating uncertainty about its future return. Second, it is clear that while there are separate national currencies, transactions costs will be incurred when exchanging them, whether it is for commercial, investment, or tourist purposes.

Uncertainty

Here the proponents of a single currency probably have a strong case. Exchange rate fluctuations undoubtedly add to uncertainty and so, other things being equal, reduce any given level of trade. Hedging against fluctuations can be expensive; and may not readily be available for periods of more than a year or two ahead, particularly for smaller firms (despite growth in the swaps market). They are, therefore, a deterrent to longer-term investment, particularly investment orientated towards export markets. The creation of a single currency can, in that sense, be considered part of the completion of the 1992 programme, removing a barrier to trade.

Nonetheless, it should not be forgotten that the completion of Delors Stage I, with all currencies in the narrow band exchange rate mechanism, should greatly reduce these uncertainties without recourse to a single currency. Furthermore, monetary union cannot remove uncertainty for countries, such as Britain, with a high degree of trade with non-EC countries.

A single currency might further increase capital mobility and thus lead to a better allocation of European savings. Certainly, longer term flows of investment and savings may still be inhibited by the uncertainty caused by the scope for realignment in Stage I. There already is a high degree of capital mobility reflected in the persistence of current account imbalances within Europe, but there may be scope for more.

Labour is likely to be more mobile when people are sure of being paid in the currency which they normally use, or which they may wish to repatriate, even when working abroad. As in the case of trade, a decision to take a job abroad involves an element of investment; a reduction in the uncertainty of the return on this type of investment would presumably lead to more of it. Interestingly, the Commission does not mention this gain from a single currency, perhaps because, from the point of view of the poorer countries, risk of losing skilled labour is hardly an attraction. The Commission want to keep the poorer countries on board the Delors train. Equally, the wealthy countries might not be very enthusiastic about limitless migration from their poorer neighbours[23].

In any case customs, nationality, fiscal regimes and languages are more likely to impede labour mobility than the existence of separate currencies.

Transactions costs

The Commission paper argues that only full monetary union can eliminate transaction costs. It estimates their cost to be between ECU 13 billion and 19 billion, or 0.3 to 0.4% of the Community's GDP[24]. In addition to the cost of conversion services performed by banks, companies bear internal costs through doing business in many currencies. Companies would also bear indirect costs from the lack of complete transparency of price comparisons which only full monetary union can bring.

Transactions costs would undoubtedly fall with monetary union but it is important not to exaggerate this[25].

First, many of the gains will come with Stage 1 of Delors. Increased competition generated by the completion of a single market in banking services is likely to reduce the average cost of currency transactions, and by a substantial amount. The Commission comes close to accepting this by saying:

> 'the relatively high expenses and long delays cross-border payments in the Community suffer from are in the first place due to the existence of several technical barriers that need to be removed in the internal market framework'[26].

Second, the Commission's estimate may well inadvertently include some costs which are merely the cost of transferring funds (in whatever currency they may be denominated) rather than exchanging currencies. If money is transferred from one bank to another, by banker's order, there is likely to be a charge for it, whatever the currency. Transactions costs in the United States, for example, can be substantial across single state frontiers, even though of course conducted in a single currency.

On transactions costs Karl Otto Pöhl has summed things up forcefully:

> 'The repeated references to alleged huge savings in transaction cost for the countries of a single currency area are not in the least convincing.'[27]

Public policy and finance

The Commission and others have argued that by preventing governments from obtaining access to central bank finance (in the current jargon this is known as monetary financing of deficits) they would have to evaluate borrowing at its true cost and therefore there would be strong pressure to reduce and then eliminate public sector borrowing requirements. There is something in this but, again, much of the benefit could probably be obtained through the existing exchange rate mechanism, with ever narrower bands. The exchange rate mechanism may already be imposing some discipline on the fiscal policies of the participating states.

Controversially, another benefit which may come as a by-product of EMU, is the need to impose binding budgetary rules. Proponents argue that without rules the Community would be underwiting the creditworthiness of each Member State's fiscal stance, a massive temptation to borrow irresponsibly. This is the Bundesbank's view. Opponents, including Britain, argue that by denying the existence of guarantees by means of the so-called 'no bail-out' rule, the market would discipline potential miscreants.

It is implausible to suppose that an ESCB could permit a Member State to go bankrupt, in which case the credibility of a 'no bail-out' rule is questionable. This points to the need for some rules for limiting budget deficits, which was proposed by the original Delors Report, later dropped, to the chagrin of the Germans[28]. A possible alternative to binding rules might be to issue firm guidelines backed by tough sanctions such as withholding Community regional or agricultural spending.

The Commission also argue that the debt interest element of government budgets would be reduced as interest rates came down in previously inflation-prone economies. However, reductions in nominal interest rates that simply correspond to reductions in inflation do not make government finance any easier, because the reduction in debt interest payments is fully offset by a reduction in the so-called 'inflation tax'; or, put another way, by a reduction in the size of budget deficits that is consistent with a sustainable fiscal position. Moreover, it should be remembered that long-term debt with a 10 or 12 per cent coupon becomes extremely difficult to service at zero inflation.

Another minor public finance gain would be savings in the use of foreign currency reserves. Foreign exchange would no longer be needed to finance trade within the EC. The gain is unlikely to be great: how much, if any, would depend on the difference between the return earned by marginal reserves at present (eg the US Treasury Bill Rate) and their return in alternative uses.

The international economic and financial system

There is perhaps something in the argument that monetary union would give European countries leverage *vis-a-vis* the dollar and the yen and that, inasmuch as benefits are to be had from international economic and monetary co-operation, monetary union would enable such benefits to be delivered more easily than under the existing multi-currency system. There may also be some seigniorage gains generated by increased holding of the EMU currency by third parties.

Nonetheless, none of those gains could on their own be considered worth the risk and upheaval of creating a single currency.

Regional imbalances

The Commission implies that the regions, by which they mean poorer areas, could get hit by monetary union. It admits that a potential cost of monetary union would be the exacerbation of already existing regional imbalances and suggests increased regional funding as compensation.

Naturally, the loss of exchange rate flexibility removes the opportunity for countries to use monetary policy as a means by which to absorb shocks. (Of course, shocks are only of concern if they affect some countries more than others. A discreet rise in the price of a commodity which all countries, per capita, used roughly equally, would not have much relevance for the debate on monetary union.)

Remember that shocks such as an oil price hike can, in principle, affect the richer countries of the Community as much or even more than the poorer countries. European monetary policy is still available to deal with such Europe-wide shocks.

It is a myth, however, to suppose that nominal exchange rate depreciation (or appreciation for that matter) can ensure a permanent adjustment/improvement to competitiveness. Any initial gain in competitiveness from depreciation may well be eroded in time by subsequent inflation. Higher import costs will see to that. Likewise the old argument, that monetary union would inhibit countries from keeping to an optimal inflation/unemployment trade off, has been discredited. This dismisses a whole body of economic literature associated with belief in a long-run Phillips Curve, but at least it follows the orthodoxy of the majority of economists in the '80s[29].

A far more effective way of restoring competitiveness is to create the conditions in which factor costs, particularly wage costs, can adjust to any shocks. However it would be difficult to sustain the view that exchange rates can *never* play a role in helping to adjust to shocks: the exchange rate can probably assist adjustment to very big shocks, so big that even fairly flexible economies would find them difficult to absorb quickly. Nor can it be concluded that exchange rate depreciation will always be inflationary. The fall in sterling in 1981 and the dollar in 1985 can both be said to have assisted adjustment in ways consistent with reducing inflation.

There will inevitably be more shocks in the future. We are experiencing one from the Middle East now. Perhaps one day Europe (and the US and Japan) might finally grasp the nettle of eliminating agricultural support. That would be a shock in more ways than one. More shocks may yet emanate from German unification. And without doubt there will be further ones, as yet unforeseeable.

It is, of course, true that the more inflation-prone countries in the European Community might find themselves faced with particularly difficult economic problems in the short term. But the case for additional regional funding (or indeed any regional funding at all) to alleviate this is quite unproven.

There is a strong case for saying that, in general, the more regional aid is given the less likely it is that the structural adjustment takes place, if only because aid distorts the market signals which can spur adjustment. In theory at least, one should ask all countries, and particularly the more inflation-prone ones, to undertake radical reforms guaranteeing more flexible cost structures, particularly wage rates, as a condition of entry into full EMU. There should be no restriction of ways in which regional labour markets can compete and adjust. In other words, a very sceptical eye should be cast at the Social Charter.

That is what the theory says. It is also what history says. Japan was a poor, trade-dependent country. She caught up without depreciating the exchange rate: quite the contrary — the yen has appreciated over the years.

On economic grounds the problems of regional imbalances should not stand in the way of EMU. All the same, the fact that several countries might persuade their partners to indulge in massive fiscal transfers (despite the economic arguments against), is a good reason for those countries which may face paying the regional bills to hesitate. Furthermore, EMU has already led to calls for measures to co-ordinate

EC-wide wage setting, which would reduce wage flexibility and wage differentials between the regions. Were those calls to be heeded then EMU, far from being associated with more flexible cost and wage structures which would tend to erode regional differences, could have the opposite effect, bringing with it an extension of Social Charter legislation and the social action programme. These twin dangers, of higher and probably pernicious regional spending and of greater regulation of labour markets, are not negligible.

Summary

The benefits of monetary union have been exaggerated, but then so have the costs. Of the economic benefits listed by the Commission and others, the capacity of EMU to deliver sound money is by far the most important.

Monetary union is not a cure-all for inflation. It might lead to greater price stability, it might lead to less. And the yardstick by which we must judge it is not some Latin American style inflation-prone region, but a highly successful anti-inflationary strategy dominated by the Bundesbank. That is what we have at present. Whether monetary union would deliver price stability would largely depend on the structure of the European central bank and, in particular, on how far the French ensured the direct political 'accountability' of that institution to European politicians. If they did get their way my guess is that it would be inflationary — at least compared with the ERM. On the other hand, if Bundesbank dominance and independence were to be replicated at a European institutional level there might be real hope, in the medium term, for price stability, comparable to that of the ERM in Europe.

Even the strongest advocates of EMU would be hard put to argue that it would do better than the ERM. It must also be remembered that Bundesbank type credibility cannot be created by fiat. The success of the Bundesbank owes much to their record for taking tough decisions[30] and relative independence. The jury of the markets would be out. Only after a number of years would they deliver their judgment. Nor is independence enough.

As for the other alleged economic benefits of EMU, monetary union would reduce but certainly not remove transactions costs. But some of these costs would be removed as a result of the 1992 programme, anyway. The public finance gains of monetary union have also almost certainly been exaggerated; and, again, many of the pressures making for prudence in fiscal policy already obtain under Stage I. The benefits of a European role in the international financial and economic system are easily exaggerated; the Commission's rehearsal of these arguments may reflect their desire, common to all institutions, to create a role for themselves, rather than their belief in the arguments.

Only the removal of exchange rate uncertainty would seem to have survived detailed scrutiny as an important economic benefit of monetary union. That benefit is not susceptible to measurement, though it may be substantial.

Finally, the problem of regional imbalance as a cost of monetary union is largely false. It is true that monetary union would require the more inflation-prone countries to make substantial adjustments. But that is an argument against a headlong rush into EMU.

More generally, there is a case for saying that the single market process cannot be completed, particularly on the capital side, without monetary union. But moving to monetary union prematurely would also cause problems: the need for adjustment generated by the 1992 process may threaten any new monetary structure.

In sum, the economic case for monetary union is there, but it is by no means overwhelming. And this is particularly true when considered against the background of the reforms already undertaken as a consequence both of the Single European Act and of the development of the exchange rate mechanism of the EMS.

4
What should Britain do now?

It is very likely that some form of treaty for monetary union will emerge from the IGC process, notwithstanding reservations voiced in Rome by several countries. What should Britain do?

This paper has three clear implications for policy. First, Britain must engage fully in the politics of EMU and seek to maximise her influence with the main players, France and Germany. Second, Britain should drop the rhetoric of sovereignty, which has been an impediment to her full participation in the debate. Third, armed with the greater credibility which would result from the above, Britain should engage her Community partners in a thoroughgoing debate both about the economic benefits to be derived from monetary union, which have been exaggerated, and about the merits of different types of monetary integration, which have been neglected.

Britain and the Franco-German alliance

Britain should form a closer relationship with Germany. The opportunity exists for two reasons. On the one hand, the greater German self-confidence of recent years, reinforced by unification and by the slow but steady decline of war guilt, is eroding the cardinal requirement for German policy makers to place France first in their foreign policy priorities[31]. On the other hand, British instincts on a whole range of economic, trade and financial issues are closer to those of Germany than of France, whose protectionist, *dirigiste* and administrative practices are alien to the British.

It would be wrong to suppose that diplomacy towards Germany could deliver an instant transformation in British negotiating influence, or a dramatic reorientation of European policy on monetary union. Negotiations are well advanced. The momentum behind EMU remains strong. There will also be a price to pay for Britain's long period of comparative marginalisation. British overtures to the Germans would be treated with initial caution by Bonn. The Germans would not suddenly reconsider their foreign policy of the past 40 years in which the overriding objective has been to sustain an alliance with France[32]. Nor will it be easy overnight to dispel the suspicion that perfectly legitimate economic reservations about the benefits of monetary union and the type of monetary union proposed, were not wrecking tactics.

Nonetheless, even in the short term the British now have more scope for manoeuvre. The inaugural session of the IGC in Rome saw a change of mood. Several Member States showed a more serious appreciation of the transitional difficulties of moving from Stage I to Stage III of Delors. Differences of view among Member States of how to achieve EMU are now emerging, as is domestic political debate and controversy in France and Germany. There is also, of course, awareness that decisions on EMU could powerfully influence the speed of Community enlargement. All these developments will assist Britain's full participation in the debate. Britain's natural ally in much of this (the hard ecu proposal excepted) is likely to be Germany, and within Germany the Bundesbank's statements on EMU most closely reflect British attitudes.

The Rome II Summit was a demonstration of how much the style and presentation of British policy matters. In recent years it had become semi-disengaged, exhibiting a form of diplomatic Micawberism. That cast of mind served to reinforce Britain's isolation from the heart of the debate. Indeed, the virulence of some of the attacks on even the principle of further measures of monetary integration only served to strengthen the will of France and Germany and to throw them into each other's arms. The change in style in Rome not only helped to erase the impression of British isolation and paved the way for full engagement in the debate, but also enabled light to be brought to bear on the differences of view both within France and Germany, and between them, on the handling of the IGCs.

The *apparent* breadth and homogeneity of support for EMU in both France and Germany is now showing signs of fracture. In France, the Gaullist RPR has come out against monetary union. The *Tresor* has never been as enthusiastic about EMU as the Quai D'Orsay. In Germany there are now important differences of view between Helmut Kohl and the Bundesbank. Chancellor Kohl seems to be seeking to trade a measure of monetary and economic independence in exchange for French and European agreement to further steps towards political integration. By this he appears to mean, and certainly Foreign Minister Hans-Dietrich Genscher means, greater powers for the European Parliament, and further development of a European foreign and security policy. The Bundesbank by contrast, fighting for its very survival, has been arguing trenchantly against linkage between the political and economic IGCs.

Differences of view are also emerging between Member States. This is reflected in some interest from the French, and a good deal of support from the Spanish, for the British hard ecu proposals. More important are the differences of view between the French and the Germans.

The core of the Franco-German debate is now largely a trade-off between the desire of the French to obtain monetary union and the desire of the Germans to obtain a measure of political union. The French still appear determined to find a means whereby they can exercise greater control of the Bundesbank; President Mitterrand supports further political integration, but mainly through strengthening inter-Governmental bodies such as the European Council. Chancellor Kohl, by contrast, still appears determined to stand by his resolve to trade monetary union for his own agenda.

The will of the French and the Germans to obtain their respective objectives will be crucial to the fate of EMU. Their determination will have been weakened not only by domestic differences of view but also by the cold shower dealt by the Gulf war to hopes for a common security policy.

The shambles immediately before the shooting started was reminiscent of Europe's disarray after the Yom Kippur war in 1973. In particular, the decision of the French at a crucial time to launch their own initiative illustrates their continuing attachment to the pursuit of an independent foreign policy and exposes the elusiveness of a European consensus on defence matters; France's solo efforts have a parallel in her encouragement of Syria to remain intransigent to American efforts to secure a ceasefire in the Yom Kippur war[33]. As in 1973, the Middle East crisis is a major setback for supporters of rapid progress towards political union, particularly on security matters.

Nonetheless, the fact that Chancellor Kohl has been so determined to obtain political objectives is a reflection of how far leading German politicians still feel the need to put the unification of their country in a European context[34]. Friendly overtures from Britain can, over time, begin to show that some political reassurance may be obtained through alliances other than with France, and through institutional arrangements other than those at present on the IGC agenda[35].

Sovereignty

The British Government should quietly drop its claim that EMU must involve an irrevocable loss of sovereignty, either for Parliament or the executive. The claim has not served Britain well. By clinging to it she greatly reduces the chances of persuading the French that their negotiating position is a mistake[36].

So long as the British claim that sovereignty is there to be lost, the French can be excused for believing that it is worthwhile ensuring that Germany loses it. For it is just such an erosion of German sovereignty which the French seek in these negotiations. The erosion of sovereignty has also been an aspiration of the Commission, and is partly responsible for the type of monetary union proposed in the Delors report. For the alternatives to Delors all have one feature in common; they involve a far smaller degree of surrender of control over one's own affairs than Stage III of the Commission's proposals.

The economic debate on EMU

Britain should publish its own comprehensive analysis of the real costs and benefits of monetary union as compared with Stage I of Delors. The Commission's recent paper on this, entitled *One Market, One Money* is flawed. An attempt to develop the kinds of points which should be addressed is made in Chapter 2 above. It is to be regretted that, both in Britain and even more so in other Community countries, many of the alleged economic benefits of monetary union have been taken on the nod. Nor have the problems of structural adjustment and the case for greater convergence of economic policies before monetary union been given their due attention.

As with the economic costs and benefits of monetary union so with types of monetary union, Britain should articulate other ideas. An outline of some other routes to monetary union is set out Appendix II. It is regrettable that debate has been allowed to centre almost exclusively on proposals put forward by the Commission. Their revised proposals may be somewhat less objectionable but other routes to greater monetary integration are also well worth considering. Notwithstanding the political momentum still behind the Commission's proposals the intensive debate about exactly what is to be signed (probably at the end of 1991) and ratified (probably by the end of 1992) by governments has only just begun. Even signature to a set of proposals would not entirely rule out revision or reversion to an alternative at a later stage.

The British have, of course, already entered this debate, with the idea of 'competing currencies' and, more recently, the hard ecu proposal. Both these proposals have weaknesses, though not necessarily insuperable[37].

Overall, the shortcomings of British policy on EMU have been no more than a reflection of the shortcomings of policy towards the Community as a whole in recent years, in which the appearance of isolation, combined with vigorous attacks as if from outside the Community, served to prejudice the credibility of British initiatives and to bind the Franco-German alliance more firmly together, and in a form inimical to British interests.

There is still much to play for in the IGCs. In seeking to further British interests one should be wary of romanticism: both the isolationist romanticism of those who oppose EMU on the grounds that it might somehow conflict with centuries-old traditions of an island people, and the federalist romanticism of those who seek to subsume the inevitable tensions of European political life in institutional constructs. Both serve Britain ill.

Appendix I

Technical problems of withdrawing from EMU

Clearly it would be possible to extricate oneself from monetary union if the disentangling process took place while separate currencies, albeit fixed, continued to exist. Even the strongest proponents of EMU expect this to be the case for several years to come. The unbundling of a single currency would be harder. For example, what would be Britain's[38] reserves monetary base? What would be her reserves?

On the question of the monetary base, if the ESCB (the European System of Central Banks) was 'federal' in character, with identifiably separate balance sheets for national central banks, and most of the system's assets held in them rather than in the central bank, that would greatly assist the disentangling process.

If, furthermore, British clearers held their operational reserves at the British branch of the central bank it would be possible to identify the monetary base for the national currency and to establish those deposits of the commercial banking system which should be denominated in the new currency.

On the other hand, if the British portion of deposits in the banking system could not be readily identified, and there were no such reserves, individual holders would perhaps have to be given a choice between keeping their deposits in ecus or transferring to the new currency. If so, the size of the new currency would be decided in part by market choice.

There would be the further complication of the ownership of deposits with British banks put there by Community residents. These depositors might well object to the redefinition of their deposits as pounds, rather than ecus. It would, of course, be open to them to withdraw their deposits.

The above outlines some of the considerable problems of disentangling broader measures of money. As for narrow money, notes and coins issued in Britain would presumably be distinguishable in some way, following the practice of US Federal Reserve district banks, perhaps marked by some British symbol such as the Queen's head. This would greatly simplify the task of establishing whose money was whose.

Considerable instability could attend the creation of a new currency. Presumably it would be necessary, on divesting day, to attempt to start with a one-to-one exchange rate. Depending on the circumstances of the withdrawal from monetary union, there could be a massive and disruptive exodus from the new currency, for example if it were thought that the new pound would be more inflationary than the ecu which it was leaving. Conversely, if the pound was leaving an ecu perceived to be inflationary, there could be a massive influx of funds.

Interest rates would bear the main burden in any attempt to bring a measure of stability. They would need to vary to compensate for any of this immediate pressure. Sharp rises in interest rates might result and these could have severe destabilising and disruptive influences, not only for individuals but for businesses as well.

As for the depooling of foreign exchange reserves, some guidance might be given by the central bank statutes. In the recent draft of the central bank governors, it is proposed that there should be a 'key' for the establishment of reserves by each national central bank. That key could determine who owned what[39].

This might still leave the awkward question of who owned the accumulated undistributed profits on the reserves. However, the statutes of the central bank are also likely to provide guidance on this, perhaps on the basis of contributions to the system's capital base.

The ESCB may develop supervisory responsibility for some truly cross-frontier financial institutions with business in a number of Community countries, and this it would presumably retain. It should be possible also to maintain the existing clearing and settlement system to cope with the revival of sterling. There would, of course, be considerable problems for firms, and to some extent individuals, who would have to re-establish facilities for handling foreign currency where previously they had required none.

Another approach to the unscrambling of sterling from a European single currency might be to take advantage of the British proposals on the hard ecu, but in reverse. The British Government could decide to issue a hard pound as a competing currency which it declared would never devalue against the single currency from which it was leaving. This could prove a useful approach if it had been decided to take sterling out of the single currency because of fears of European inflation. Furthermore, it is likely that there could be considerable demand for the new hard sterling if it was backed by the firm commitment of the British government to press ahead with the recreation of a British currency. The substitution would probably be far swifter than from individual currencies to the new hard ecu.

Appendix II
Some other routes to EMU

The idea that monetary union should be defined only in terms of a single currency administered by an independent European central bank is a recent one. In the 1970s proponents of monetary union put forward a raft of other proposals. In the 1970s Roland Vaubel, amongst others, proposed a move to monetary union through currency substitution and a parallel currency[40]. F A Hayek proposed the 'privatisation' of money to enable currencies to compete[41].

Another contribution came in the so-called 'All Saints' Day Manifesto', first published in *The Economist*, a form of non-inflationary parallel currency not dissimilar to Britain's proposals for the hard ecu[42]. Indeed, many of those who proposed these ideas did so because EMS-type schemes such as 'the snake' and the Werner Plan to which many had been attracted, seemed to have failed.[43]

The completion of what is now known as Stage I of the Delors Plan would probably have been looked upon as monetary union in the 1970s. This is hardly surprising since, as is shown in Chapter Two, most of the benefits commonly ascribed to the creation of a single currency are obtainable under those arrangements.

The defects of the Delors Report have been very widely discussed and examined. The call for restrictions on the size of budget deficits, for increased regional spending, the lack of accountability for monetary policy to any democratic authority and the weakness of its analysis of the transition from Stage I to Stage III have all provoked controversy and criticism[44].

A rival to the Delors scheme is not prescribed here. However, some other schemes which have not received due consideration are briefly examined.

Strengthening the EMS

If economic arguments were the prime movers in the pressure for greater monetary integration, one would expect a good deal of support for building on the currency system we have at present. However, as has been explained, the pressure for further monetary integration is largely political, not economic. Sir Leon Brittan seemed to acknowledge this when he dismissed building on the ERM by saying:

> 'this is politically difficult for both countries that have to follow the lead and also for the leading country itself which finds itself saddled with a reserve currency role which it may not be willing or able to undertake effectively'[45].

There has not, so far, been a great deal of evidence to suggest that the Bundesbank has been carrying out their role in the ERM ineffectively, nor does it seem unwilling to continue to do so.

There is certainly scope for building on the ERM.

With the abolition of capital controls, the completion of the single market in banking, the move to 2½ per cent exchange rate bands for all currencies and, as has been the case in recent years, eschewal of realignments to accommodate inflation, there will be strong pressure on the domestic monetary authorities to bring about convergence of monetary policies.

In addition, a move to narrower bands of, say, 1, or even a ½ per cent, would impose a tough monetary discipline and might also encourage governments to consult on anti-inflation objectives and interest rate policy.[46] Narrow bands are likely to generate convergence of policy, with or without consultation, as has happened between France and Germany, making realignments rarer.

Market expectations would play a crucial role in the success of such further monetary integration. Markets would need to be convinced that inflation rates were converging and, along with them, interest rates.

Building upon Stage I in this way could be complemented by consultation to develop a common policy for currencies in the ERM vis-a-vis the dollar and the yen, building on the informal understandings which have already grown up. It is conceivable, although perhaps not necessary, that such close consultation could be formalised. Formalisation of the process might serve to protect Member States against the possibility that external exchange rate policy was being decided largely by the Bundesbank.

The consultations described above could be formalised through an enhanced Monetary Committee, Committee of Central Bank Governors or some other body, perhaps with some of the powers envisaged for the European Monetary Fund under the British hard ecu proposals[47]. It could additionally, but perhaps unnecessarily, be given powers to manage foreign exchange reserves and to intervene in foreign exchange markets in order to deliver agreed exchange rate policies.

British proposals

Two approaches have already been put forward, both by the British Government. The first, the proposal for allowing currencies to compete to provide a non-inflationary anchor in the EMS, has been widely criticised on at least two grounds.

First, if it were successful, it would probably lead to the ascendancy of the deutschmark. (It is not clear that this would necessarily be so unacceptable to most governments of Europe. Many would be only too happy to be able to share in the success of West Germany's post-war monetary stability.) Second, it has been pertinently pointed out that good currencies tend to drive out bad only where the bad currency suffers hyperinflation. Both these criticisms have some force, the first political, the second economic.

The hard ECU

The British Government's second proposal builds on a long pedigree of non-inflationary parallel currency ideas[48].

The British have proposed the creation of a European Monetary Fund (EMF) which would have responsibility for issuing hard ecus. The most attractive aspect of this proposal is that it should be non-inflationary. The hard ecu would be as strong as the strongest Community currency. It would never devalue against another Community currency. The EMF would have to set interest rates at the level required to meet that obligation, however high that might be. A discipline on inflation-prone countries would be that Member States would be required to repurchase their own currencies from the EMF with the hardest currency then prevailing in the Community, or as specified by the EMF. This would prevent the creation of hard ecus from adding to the money supply. It is these key features which distinguish the British parallel currency proposal from most other parallel currency proposals[49]. Most parallel currency schemes have foundered on the problem that adding an extra currency would be inflationary, as both the Delors Report and the Bundesbank were swift to point out.

The EMF could also manage the Exchange Rate Mechanism of the

EMS, and co-ordinate exchange rate intervention against the dollar and the yen, amongst other tasks.

Besides being non-inflationary, the proposals have the merit of being gradual and evolutionary. This would give more time to the more inflation-prone countries to make the necessary structural adjustments.

To some extent, the same criticism that is made of the competing currencies proposal can be made of the hard ecu proposal, that the gap in inflation rates would not be enough to drive out other currencies[50]. Of course, it is arguable that massive currency substitution is not a necessary condition for delivery of greater discipline in countries with lax policy. Merely the potential for a large switch into a hard currency may be enough to exert discipline.

It is likely, too, that the hard ecu would have little advantage over the deutschmark so long as the latter retained its anchor role in the ERM. Indeed, until the hard ecu became widely traded the deutschmark would be a preferable asset since its wider circulation would almost undoubtedly deliver lower transactions costs.

Gold or commodity-based standards

One of the forms of monetary union with the longest pedigree is, of course, the gold standard. Volumes have been written for and against gold over the years. Whatever the theoretical merits and notwithstanding the relatively good track record of gold, it is extremely unlikely that most Member States would wish to tie their currencies to a commodity with such a vulnerable price history and which is so susceptible to shocks. Few countries would be prepared to see their competitiveness eroded by civil war in South Africa or unrest in the Soviet Union, for example.

A more stable variant of the gold standard would be a commodity-based standard in which the value of a currency would be defined according to a basket of commodities. These would be selected and weighted with the express objective of finding that mix which best stabilised prices. The best commodities for this purpose would probably be those which are the key determinants of inflation/deflation.

World demand would probably be a major determinant of the value of the commodity basket. High demand would lead to the appreciation of European currencies against the dollar and yen, and vice versa. This would, of course, stabilise activity and prices in the

European economies, but not in the US and Japan. It could lead to pressure from those countries to join the commodity basket or, alternatively, to international economic friction. The problems of storing commodities would probably greatly reduce the opportunity for destabilising speculation in the markets, a problem inherent with gold.

Sir Alan Walters has recently proposed a form of commodity based standard[51]. He argues that it is sufficient to make currencies redeemable against a financial asset which carried the power to purchase a given basket of commodities, or services. With the use of this 'indexed reserve asset' it would not be necessary physically to store commodities.

Notes

1. In this paper EMU is used as shorthand for monetary union while recognising, of course, that the economic aspect embodies all those reforms envisaged as a consequence of the Single European Act, and probably more besides.

2. The 2 + 4 negotiations demonstrated vividly for the French the limits of the Franco-German alliance. Helmut Kohl's direct negotiations with Mr Gorbachev were far more important in determining the outcome than any advice or pressure from Paris.

3. The objectives in Europe of the Bush administration have been twofold. First, it has sought to obtain the withdrawal of all Soviet troops from non-Soviet soil, including East Germany, as soon as possible. In this US interests coincided with those of West Germany and contrasted with the more ambivalent attitude towards a Soviet presence on German soil emanating from France and Britain in the autumn of 1989 and spring of 1990.

Second, the US wished to preserve their role in Europe. The most important vehicle for that was NATO, and the best way to secure the retention of a role for NATO and to keep a military presence in continental Europe was by working with the Germans. These objectives took priority over any concerns the US may have had that the unification of Germany might upset the power balance in Europe. The removal of Soviet troops from Europe was of crucial domestic political significance for the US; it was a demonstration of the victory of the West in the cold war.

4. Three legs of French foreign policy have recently been gravely weakened, in the Middle East, in Africa and in Europe. First, the invasion of Kuwait exposed its fragility in the Middle East, a policy which extended far beyond decisions on arms sales. The collapse of France's friendship with Iraq has shaken the whole structure of her Middle East relationships. Second, France's long-standing relationship with her former colonies in Africa is now being exposed as a costly post-Imperial legacy, one of which the central administration would like to be rid. Third, notwithstanding France's token repudiation of the *de facto* division of Europe decided at Yalta, French security policy had,

at least to a large extent, been based on the continued division of the Germanies. With unification that leg of policy has been removed.

5. Perhaps Helmut Kohl, by explicitly repudiating any further territorial claims on his neighbours (and by his pro-European advocacy) is reflecting the dictum of Bismarck: 'Nothing could be more dangerous for Germany than to play the part of a man who has suddenly come into money and now throws his weight around' (quoted in the *Daily Telegraph* 17.7.90).

6. Many senior German officials privately expressed reservations about the pace and direction of the drive towards EMU from the start. Some of this surfaced in public and was reflected, for example, in the report of the Board of German Economic Advisers to the Bundesbank.

7. In a search for that independence last year the Bundesbank quietly negotiated with the French in an effort to obtain agreement to some kind of Schengen group proposal, one in which Germany, and hence the Bundesbank, would remain the dominant partner. A smaller group would also increase the chances of enabling the Bundesbank to secure other objectives, for example binding rules on budget deficits and a lengthy period of adjustment in which non-participating countries' economies were given time to converge.

8. Karl-Otto Pöhl has made the same point: 'Significantly enough, the proposal to create a European currency and a European Central Bank, did not come from the Minister of Economics or Finance, let alone the Bundesbank, but rather from the Minister for Foreign Affairs.' Speech in Munich, 3 September 1990, reproduced in *Europe's Constitutional Future*, IEA, 1990.

9. Karl-Otto Pöhl put this graphically: 'in the Deutschmark we [the Germans] would be sacrificing a hard currency on the European altar without knowing what we would be getting in return.' Op.cit. p.36.

10. The arguments here are set out with reference to Britain but they are, for the most part, valid for other Member States.

11. Definitions of sovereignty abound. Here I have taken Geoffrey

Marshall's definition of Parliamentary sovereignty:

> 'Where a parliament is sovereign (as is the parliament of the United Kingdom) it has an unlimited authority, recognised by the courts, to make any law or to amend any law already made. In consequence no other body or court has the right to overrule or set aside its legislation' (Quoted from V Bogdanor ed., *The Blackwell Encyclopaedia of Political Institutions*, Blackwell, 1987).

12. For an interesting analysis of this question, see, 'Sovereignty and the Eurofed', in the *Political Quarterly*, by I J Harden, University of Sheffield, October 1990.

13. A striking example of the erosion of control as a result of the Treaty of Rome is the recent 'Barber decision' of the European Court of Justice which held that occupational pensions are a form of pay for the purposes of Article 119. This requires that men and women should receive equal pay for equal work. The financial implications for the pensions industry are enormous, running into many £ billion.

14. In constitutional theory it could be said that Parliament has always delegated responsibility for monetary policy to an agent.

15. The Community has, for example, acquired considerable powers in determining the size of the VAT base and the Common External Tariff.

16. It is often held by supporters of EMU that even discussion of any putative dismemberment of an EMU would greatly reduce its chances of success. The irrevocability of a single currency, it is held, is central to its credibility in the markets and elsewhere. There is force in this argument. Nonetheless, whether or not there is widespread discussion of it, Parliament would possess the sovereign authority to withdraw.

17. For a succinct description of the recent history of monetary unions and systems see *Efficiency, Stability and Equity*, Tommaso Padoa-Schioppa, p.p. 17-25, 1987.

18. The idea that Britain would no longer be an independent nation after EMU has been trenchantly argued by a wide spectrum of opinion

in the House of Commons. Professor Tim Congdon also takes this view in his paper *EMU Now?*, Centre for Policy Studies, 1990, p.30.

19. For a cautionary note on subsidiarity see *Subsidiarity, as History and Policy* by Andrew Adonis and Andrew Tyrie, IEA, December 1990.

20. Nonetheless, even with membership of the exchange rate mechanism Britain retains the residual power, after consultation, to realign.

21. For example, *Economic and Monetary Union: the Economic Rationale and Design of the System*, European Commission, 1989; and *One Market, One Money: an Evaluation of the Potential Benefits and Costs of Forming an Economic and Monetary Union in the European Community*, The European Commission, 1990.

22. *An Evolutionary Approach to Monetary Union*, HM Treasury, November 1989.

23. It might be argued that such migration, the right to which is embodied in the original Treaty of Rome, might ultimately pose a far greater threat to national identity than new constitutional arrangements for monetary policy.

24. *One Market, One Money,* op. cit., p.251.

25. It can be argued that the 'City of London case' for EMU has been exaggerated. At first sight one might imagine that parts of the City would find the prospect of the removal of opportunities for intra-EC exchange dealing as deeply concerning. Perhaps surprisingly, the 'City view' has been that they would greatly benefit from EMU and London's reputation as a financial centre would be tarnished if Britain stood aside. This argument is not entirely convincing.

The City has benefited enormously on occasion by being outside a major centre of regulation. For example, Wall Street regulation brought much of the Eurodollar market to London. Nor is it necessarily true that a particular economic zone necessarily maintains its financial centre within that zone. For example, Switzerland is one of the financial centres of the German speaking world; Luxembourg also benefits from being outside the German regulatory sphere. A quarter of the international German bond market is traded in London; about a third of French equity business is traded there. These examples also show that it is not necessary to operate in the same currency in order to obtain the business.

26. *One Market, One Money*, op. cit. p.262.

27. IEA Readings, op.cit., p.36

28. No doubt the Commission's initial enthusiasm for budgetary rules was also fuelled by the hope that some central authority might acquire broader powers of fiscal co-ordination, perhaps for the purpose of demand management.

29. An early exponent of the view that the cost of joining a monetary union would be small if monetary policy could not sustain a higher level of unemployment was Professor Parkin. See his 'An Overwhelming Case for European Monetary Union', *Banker*, 1972.

30. As William McChesney Martin, US Federal Reserve Chairman from 1951-1970, said: 'The Fed's job is to take away the punch-bowl just when the party is getting going'. IEA Readings, op.cit., p.39.

31. When I once asked a senior official in the *Bundeskanzleramt* why it was that Paris had been informed about a German intiative a full week before London, he replied that I must understand that Bonn always clears its foreign policy initiatives with Paris before launching them. He continued that the Germans did not find their relationship with the French easy, but they worked at it because they had to.

32. It is arguable that a great opportunity to forge a closer relationship with Germany, and thereby obtain more leverage in the EMU and other debates was missed in the months after the collapse of the Berlin Wall. British policy towards Germany was leaden-footed. At first, no support came from Britain at a crucial and testing time for Germany. When it did come, it sounded correspondingly less sincere. Some of the damage done to Anglo-German relations during these months of indecision was repaired at the Konigswinter Conference in

Cambridge in Spring 1990, but an opportunity for a radical reshaping of Anglo-German relations had passed.

33. Coral Bell, *The Diplomacy of Detente*, 1977, pp.91-2.

34. In October 1990 Helmut Kohl said, 'With the ending of division the Germans have gained full sovereignty. However, in an age of increasing political interdependence, national sovereignty is not an object of value in itself, but a tool to be wielded responsibly in a spirit of partnership. This implies, among other things, a willingness to share sovereignty by progressing towards European integration.' Quoted in *The Financial Times*, Monday, 29 October, 1990.

35. A good deal has been written on the kind of institutional reforms of the Community Britain should seek to obtain from the IGCs. Some of the possibilities are set out in *Subsidiarity, as history and policy*, op.cit. See too Frank Vibert's recent collection of essays on constitutional reform. IEA Readings, op.cit.

36. It is mistaken first, because Germany is unlikely to pose a threat to France's security; second, because France will gain economically from a resurgence of German economic vitality; third, because even if Germany did ever try to establish some sort of diplomatic/economic hegemony in Europe, it is exceedingly unlikely that in the long run, an EMU treaty would stand in her way.

37. Some economic shortcomings of the hard ecu proposal are mentioned in Appendix 2. However, its most severe flaw is perhaps political: it is the type of proposal least likely to attract support from Germany in general and the Bundesbank in particular.

38. As with Chapter 2 the arguments here are set out with reference to the British case, though for the most part they apply to any country wishing to leave an EMU.

39. Nonetheless, it is just conceivable that Britain might lose her title to forex reserves.

40. Roland Vaubel *Choice in European Monetary Union*, IEA Occasional Paper No 55, 1979.

41. F A Hayek *The Denationalisation of Money - the Argument Refined*, IEA Hobart Paper, February 1978.

42. Set out in the *Economist*, 1 November 1975.

43. The *snake* was an exchange rate system with adjustable parities, which operated between some West European currencies between 1972 and 1978. The *Werner Plan* was a report by the then Prime Minister of Luxembourg, Pierre Werner, for the achievement of economic and monetary union. This Plan proposed an increase in Community spending, extension of regional policy and a common monetary policy with the intention of creating the conditions in which the margins of fluctuation between member currencies could be gradually reduced. The monetary aspect of the Werner Plan bore considerable similarities to the Exchange Rate Mechanism of the EMS.

44. For a good brief analysis of these and other points see *An Evolutionary Approach to Economic and Monetary Union*, op.cit.

45. *Monetary Union*, Sir Leon Brittan, CPS 1990.

46. An informal 1% band has operated between Germany and Benelux for several months. The French have also tried to limit fluctuations within the narrow band but without much success latterly.

47. Although it might transpire that there was no need for a new institution, its absence would leave the proponents of highly institutionalised Delors Stage III type monetary union very dissatisfied. Whatever the economic merits, 'ERM building' of the type described above would probably carry little political support except inasmuch as it was seen as a development of Stage II.

48. See, for example, the earlier references to the 'All Saints' Day Manifesto' and to Vaubel. It was recently resuscitated by Sir Michael Butler of Hambros Bank. According to John Williamson, of the Institute for International Economics, the idea bears a close similarity

to a Japanese proposal for the valuation of the SDR, put forward in 1973. See *Britain's Role in EMU,* Open Forum of the Liberal Democrat Party, 1991.

49. The 'All Saints' Day Manifesto' proposal would be akin to 'a super-hard ecu', because in their proposals the parallel currency would be required to increase in value by the inflation rate of the basket of currencies.

50. Tim Congdon made this point in an article 'Why a Parallel Currency is a Contradiction in Terms', *Financial Times,* 14 November 1990.

51. Sir Alan Walters, *Sterling in Danger*, 1990, p.p.114ff.