Community Topics 34

Economic and monetary union

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press and information

Economic and monetary union

CONTENTS

May 1972

Chronology

May 1957: Rome Treaty signed; it provides for the establishment of a Monetary Committee to foster monetary cooperation, and the granting of mutual assistance to countries in balance-of-payments difficulties. The member states undertake to treat their economic and monetary policies as "matters of common interest."

February 1960: Six set up Short-term Economic Policy Committee to improve coordination procedures.

October 1962: Commission calls for coordination of member states' monetary policies, in particular the creation of consultation procedures, the establishment of a common position on external monetary relations, and the negotiation of an agreement on mutual aid for member countries in balance-of-payments difficulties.

April 1964: Six set up Medium-term Economic Policy Committee to improve coordination of medium-term economic policies.

May 1964: Six set up Committee of Central Bank Governors to strengthen monetary cooperation, and Budget Policy Committee to compare member countries' budget policies.

February 1968: The Commission suggests that the following goals be studied: fixed currency parities, with exceptions by common accord only, and elimination of day-to-day currency fluctuations in transactions between the member states; establishment of mutual-aid machinery; the definition of a European unit of account.

July 1968: France's partners grant her mutual monetary aid. Commission authorizes France to restrict imports and reimpose exchange control temporarily.

September 1968: Finance Ministers of the Six authorize the Monetary Committee and the Committee of Central Bank Governors to study closer monetary relations in the Community.

December 1968: Monetary disturbances in November, especially speculation against the French franc, lead the Commission to announce that it will propose the setting up of monetary cooperation machinery.

December 1968: Council in broad agreement on need for greater convergence of economic policies.

February 1969: Commission memorandum calls for coordination of short- and medium-term economic policies, and the setting up of machinery for monetary cooperation.

July 1969: Council of Ministers agrees on closer cooperation on short-term economic policies and on the principle of a Community system of short-term monetary support. It decides to start thorough discussion of measures to strengthen the coordination of medium-term economic policies, and to study a system of medium-term financial aid.

August 1969: France devalues the franc.

September 1969: Germany "floats" the mark.

October 1969: Germany revalues the mark.

October 1969: IMF articles of agreement changed so that certain important decisions require 85 per cent majority. This enables the Six to veto proposals if they adopt a common position.

December 1969: Heads of state or government of the Six, meeting at The Hague, reaffirm their readiness to promote the Community's development into an economic union. They agree to work out a plan for the creation by stages of an economic and monetary union, and to consider the setting up of a European Reserve Fund as the consequence of harmonized economic policies.

December 1969: Commission memorandum suggests that medium-term policy harmonization would be more effective if the guidelines were expressed in figures.

January 1970: Council of Ministers agrees to the principle of a joint definition of medium-term indicators and calls for a medium-term economic policy programme. This should contain definitive economic guideposts for 1970-75 and an inventory of the main structural reforms to be accomplished at national and Community levels. Ministers also approve a short-term monetary aid agreement.

February 1970: Community central banks formally activate a $2-billion short-term mutual monetary aid system.

March 1970: Commission publishes three-stage plan for achieving a monetary and economic union by 1980.

March 1970: Finance Ministers set up group of experts under Luxembourg's Prime Minister and Finance Minister, Pierre Werner, to consider plans for economic and monetary union submitted by the Commission, Belgium, Germany and Luxembourg, and to report on ways of achieving such a union.

June 1970: Council of Ministers endorse Werner group's conclusion, in its preliminary report, that an economic and monetary union "appears to be attainable in the course of the present decade, provided it receives the permanent political support of the governments."

June 1970: Commission proposes the creation of a $2 billion medium-term mutual monetary-aid system.

July 1970: Council decides to introduce medium-term monetary-aid machinery.

October 1970: Werner group presents its final report to Council and Commission on attainment of economic and monetary union in Community by stages.

October 1970: Commission proposes that Council express its political will to achieve economic and monetary union, and agree on action programme for 1971-73, starting with closer coordination of short-term economic policies and cooperation between member states' central banks.

February 1971: Council unanimously agrees to phased programme for achieving economic and monetary union, and decides in particular to:

1. narrow exchange-rate margins between member countries' currencies;
2. create $2,000 million medium-term reserves pool to support member states suffering from fundamental balance-of-payments difficulties;
3. coordinate short- and medium-term economic and budgetary policies with regular meetings between finance ministers and central bank governors.

March 1971: Council formally adopts: resolution agreed in February 1971 on establishment by stages of an economic and monetary union; and three decisions agreed on in February 1971 on increased coordination of short-term economic policies, strengthened cooperation between central banks, and establishment of a mechanism for medium-term financial aid.

May 1971: Council authorizes temporary widening of exchange rates. Germany floats mark; the Netherlands float guilder.

July 1971: Commission proposes controls on short-term capital movements and foreign borrowing by residents; and restrictions on money-market operations by non-residents.

July 1971: Franco-German talks on monetary reform.

August 1971: President Nixon announces measures to combat inflation and deal with US balance of payments: suspends dollar convertibility and introduces 10 per cent surcharge on imports.

August 1971: Council of Ministers decides:
1. Reform of the international monetary system is necessary;
2. Member countries should be free to adopt either a single- or two-tier foreign exchange market;
3. The Central Bank Governors' Committee and the Monetary Committee should submit proposals on intervention instruments and techniques that would contribute towards a progressive narrowing of the fluctuation margins between EEC currencies.

August 1971: Italy floats lira; Benelux countries float their currencies; France adopts two-tier commercial and financial foreign-exchange market.

September 1971: Council of Ministers agrees on need for fixed but adjustable exchange rate parities, realignment of exchange rates of major currencies, and lifting of US surcharge.

December 1971: International realignment of currencies agreed, including devaluation of dollar against gold. US abolishes 10 per cent surcharge.

January 1972: Commission proposes that member states' currencies fluctuate by no more than 2 per cent against one another; earlier Commission proposals to control speculative capital movements be implemented; a European monetary cooperation fund be created.

March 1972: Member states relaunch monetary union; they agree to set up group to coordinate short-term economic policy and to narrow exchange rate fluctuations to 2·25 per cent.

April 1972: Member states' and acceding states' central banks begin to limit exchange rate fluctuations between their currencies to 2·25 per cent.

Introduction

The European Community decided in February 1971 to enter the first stage of a process which should result in a complete economic and monetary union by the end of 1980. This is one of the most important and ambitious decisions taken since Belgium, France, Germany, Italy, Luxembourg and the Netherlands signed the Rome Treaty setting up the Common Market in 1957.

The Six are aware of the profound political significance – for Europe and the world – which achievement of economic and monetary union would have for the Community and the member states. They have expressed the wish to make the undertaking irreversible.

Member states hope that in setting up such a union over the next ten years, they will help to ensure satisfactory growth, full employment and stability in the Community; to remedy structural and regional imbalances; and to strengthen the Community's contribution to international economic and monetary cooperation.

Progress towards full economic union would mean that each member country's monetary and fiscal policies would increasingly be decided at Community instead of at national level. Sales and company taxes and excise duties throughout the Community would be harmonized. For the first time there would be a genuinely integrated Community capital market. After the transition process, exchange rates between Community currencies would not be changed again. As there would be complete freedom to change one currency for another, and as exchange rates would be rigid, the Italian lira would be just as useful a currency as German marks in Germany, Dutch guilders just as useful a currency as French francs in France, and so on.

But the implications are not simply economic. If decisions were to be made at Community level, then new institutions might have to be created or the powers of existing institutions extended, so that joint policies could be decided and carried out. Community institutions would need to be subject to democratic control, so that the European Parliament would have to be strengthened. Increasing economic and monetary integration of Europe could lead to developing political integration, a trend which would accord with the concepts of those who founded the present Community.

It was the "summit" conference of the six Community states, held in December 1969 at The Hague, which gave the impetus for a full monetary union. Member countries were very conscious that, with the final phase of the Common Market about to begin, the Community had reached a turning-point in its history. By entering this final phase, the Community was not only affirming the irreversible nature of its previous progress and decisions, but also preparing the way for a politically united Europe.

First step

Early in 1971 the Six took the first step to implement economic and monetary union by the end of 1980. At a session of the Council of Ministers on February 8–9, 1971, they agreed that the first phase in the process of complete monetary integration should run from January 1, 1971, to December 31, 1973. By the end of the last phase there could be a single currency for the whole Community.

The Six declared that during the first stage they intended to:

- narrow the exchange-rate margins between their currencies;
- set up a $2,000 million medium-term reserves pool to support member states suffering from fundamental balance-of-payment difficulties (over and above the $2,000 million short-term reserves pool set up for similar purposes in February 1970);
- coordinate short- and medium-term economic and budgetary policies;
- hold regular meetings of their finance ministers and central-bank governors.

Before the end of 1973 the member states plan to take the major political decisions about the ultimate nature of the union, especially the extent to which Community institutions, responsible to a European Parliament, would have to be created and take over some of the decision-making which is at present carried out by individual member countries. Without these, a monetary union would be meaningless.

By the end of 1973 the Council has undertaken to decide whether any transfer of power to the Community is advisable. The short- and medium-term stabilization pools, and the other measures agreed will, however, continue to operate until end-1975; if the member states have not agreed by then on the Community's additional economic powers, member states could have recourse to an "escape clause", permitting them to pull out of the pool. The clause is seen as a powerful incentive to the member states to agree before 1976 to implement fully a monetary union.

The Council's agreement in principle of February 1971 was formally adopted on March 22, 1971.

The plan for economic union suffered a setback in May 1971, following excessive inflows of capital into certain Community countries. Despite the incompatibility under normal conditions of floating exchange rates with the smooth functioning of the Community's single market for all goods, the Council of Ministers agreed that the countries affected might, for a limited period, widen fluctuation margins of the exchange rates of their currencies in relation to existing parities.

Floating currencies

As a result, Germany and the Netherlands floated their currencies, i.e. their central banks ceased to support the official rate *vis-à-vis* the dollar. The Six postponed the first concrete move to monetary union: the reduction scheduled for June 15, 1971, of the margins in which the Community currencies fluctuated against each other, from 0·75 per cent to 0·60 per cent either side of par.

Following President Nixon's decision of August 15, 1971, to suspend the convertibility of the dollar into gold, the

Council of Ministers on August 20, 1971, agreed to let member states choose between fixed and free parities *vis-à-vis* the dollar. In December 1971 the world's leading industrial nations agreed on a major realignment of their currencies, including a devaluation of the US dollar against gold (from $35 to $38 an ounce). They decided to widen from 1 to 2·25 per cent the margin above and below "pivotal" rates around which other currencies might fluctuate against the dollar. Following their agreement in March 1972 to relaunch monetary union, Community countries, however, have since April 1972 maintained a narrower margin – 2·5 per cent around the central rate – for fluctuations between their currencies. They plan eventually to eliminate these fluctuations.

Why economic and monetary union?

Although the Rome Treaty does not specifically call for economic and monetary union, it is a logical development of the European Economic Community and has become an important issue. The Commission has stressed for several years the need to harmonize member countries' monetary and economic policies and their joint responsibility for mutual aid to help their partners overcome balance-of-payments difficulties.

The main lines of this policy were set out in October 1962 in Chapter VIII (monetary policy) of the Commission memorandum on a Community programme for the second stage of the transition period and in the Commission's "Initiative 1964" of September 1964.

In the 1962 memorandum the Commission affirmed that the coordination of member states' policies "would be incomplete, and therefore possibly ineffective, if no comparable action were taken in the field of monetary policy". It recommended, among other things, the creation of procedures for prior information and consultation, the establishment of a common position for external monetary relations, and the negotiation of an agreement laying down "the extent of mutual-aid obligations under the (Rome) Treaty".

In February 1968 the Commission submitted to the Council a memorandum on Community action in the monetary field. It suggested that the Committee of Central Bank Governors and the Monetary Committee should examine:

- The possibility that member states should change their currency parities only by common agreement.
- The elimination of day-to-day fluctuations around the parities of member states' currencies, and the adoption of identical ranges of fluctuation *vis-à-vis* the currencies of non-member countries. This would not only facilitate commercial and financial relations within the Community, but also allow member states to adopt a common position should non-member countries adopt floating exchange rates.
- The establishment within the Community, under Articles 108 (exchange rates) and 109 (mutual aid in case of balance-of-payments difficulties) of the Rome Treaty, of a multilateral network of mutual credit facilities which could be used by member countries in balance-of-payments difficulties.
- The definition of a European unit of account which would be used in all fields of Community action requiring a common monetary denominator.

The Commission also recommended that, while strengthening their internal monetary solidarity, member countries should declare themselves ready to respect and uphold the principles of the international monetary system as established in international agreements concluded since the end of the Second World War, and to contribute to the effective operation of this system through concerted action.

Monetary jolts in 1968-69 proved the need for a joint monetary policy. French devaluation and German revaluation shook the common agricultural market; complicated bridging regulations were introduced to keep it functioning. The lack of a common monetary policy produced not only internal disadvantages for the Community; the maintenance of different national policies also meant that, *vis-à-vis* non-member countries, the Community was unable to defend effectively its independence and its common interest, particularly in international monetary matters.

A major reason for member states' present concern with closer economic and monetary coordination is the potentially harmful effects on the functioning of the Common Market of member countries' attempts to solve in isolation any balance-of-payments problems. Events since 1968 have highlighted the possible disturbances to trade and economic development which can arise when different countries pursue independent monetary and fiscal policies. As a result of the French Government's wage settlement following the unrest in France in May 1968, the French balance-of-payments deteriorated rapidly and led to heavy speculation against the franc and in favour of the mark. France and Germany were determined to maintain existing parities, and used fiscal measures rather than exchange-rate changes in order to remove their growing balance-of-payments deficit and surplus, respectively. In November 1968 the German Government introduced a 4 per cent tax on exports and a 4 per cent subsidy on imports while the French Government increased the rate of value-added tax and introduced measures to subsidize exports.

These explicit as well as implicit taxes, subsidizing imports in the one case and exports in the other, constituted barriers to and distortions of trade between member countries. Hence they tended to destroy the idea of a common market, which was the Community's *raison d'être*. The 1968-69 currency crisis gave a strong impetus to closer monetary cooperation. On December 5, 1968, the Commission submitted to the Council a memorandum on appropriate Community policies to deal with the current economic and monetary problems. Accepting the conclusions of this memorandum, the Council on December 12, 1968, "recognized the need for fuller alignment of economic policies in the Community and for an examination of the scope for intensifying monetary cooperation". On February 12, 1969, the Commission submitted a further memorandum clarifying its position on these two points. Trade was further dislocated when exchange rates were altered: in August 1969 the French franc was devalued by 11 per cent; in September 1969 the mark was floated, and in October 1969 a new mark parity was fixed in terms of the dollar at 9 per cent above its previous value.

Units of account

Under the common farm policy, common prices throughout the Community are fixed in units of account, which have been equivalent to the gold value of the United States dollar. The system therefore comes under strain if some, but not all, Community currencies change their parity in relation to the dollar. In 1969, after the devaluation of the French franc and the revaluation of the Deutschmark, measures were taken to prevent German farmers from losing out. (Without special measures, the German farmer would have received the same dollar value, i.e. fewer marks, for his produce, and French consumers would have faced immediate price rises, as their food would have cost the same in dollars, but more in francs.) France was then allowed to maintain her former prices in French francs on condition that she moved up to the common price levels within two years. Farm imports into France from other Community countries were granted rebates to bring them down to the lower levels prevailing in France, while French farm exports were taxed to bring them up to the higher price levels of the rest of the Community. At the same time, Germany was required to maintain the common prices, causing an estimated annual loss of income to her farmers of about DM 1,700 million. A temporary system of special subsidies, paid partly by the European Agricultural Fund and partly by the German Government, was agreed.

The growing involvement of the national economies with that of the Community – particularly as internal tariffs were abolished – resulted in national instruments having less effect in controlling economic activity and national economic policy. This loss of economic freedom for the member countries was not compensated for by an expansion of the Community institutions' powers. Attempts to harmonize economic policy at Community level frequently resulted only in general recommendations, without concrete and binding terms of reference.

Lack of an effective common economic and monetary policy also hindered liberalization of capital movements and the achievement of freedom of establishment for people and firms. In other sectors, the lack of a common policy and the maintenance of national legislation and practices prevented balanced development in the Community.

Finally, it was widely felt that not only economic necessity but also the politics of integration demanded a transition to common decision-making in the whole field of economic and monetary policy.

Dollar standard

Another reason for the Community's moves towards monetary union was the growing European opposition to the *de facto* dollar standard on which the non-Communist world found itself. This situation was formalized in March 1968 by the creation of the two-tier gold system. i.e. a fixed gold-dollar ratio for settlements between central banks, and a "free" market for other transactions in gold. One of its important effects was to discourage a dollar devaluation as a way of overcoming the persistent American balance-of payments deficit ($9,800 million in 1970). Throughout the 1960s, the American balance-of-payments was in deficit and the Community balance-of-payments in surplus, with the result that European countries were forced, under existing rules, to acquire increasingly large dollar balances. This enabled the USA to pay for European products with credit obtained from the Community. In particular, there was a feeling in Europe that, by holding dollars short-term, Europe as a whole had financed substantial American purchases of European industry and had enabled the USA to increase substantially its long-term direct investment in Europe. Even in the Community's foreign-exchange markets, the dollar was used as the intervention currency to stabilize exchange rates within the limits approved by the International Monetary Fund (IMF).

Of particular importance was the phenomenal growth of the Eurodollar market (i.e. dollars held outside the US); this was largely the product of America's internal domestic monetary policy of attempting to keep interest rates below the level at which they would have been set by the forces of the free market. The growth of this market meant that the level of interest rates in all leading European countries, including Britain, was determined by US monetary policy, rather than by that of the European country concerned. If US monetary and credit policy was tight, as it was for example in 1969, and the US Government forbade a rise in interest rates on bank deposits, then increased demand for funds raised interest rates in Europe. In 1969 interest rates on the Eurodollar market rose to 13 per cent. In view of the dollar's dominance and the dependence of other countries' monetary policies on that of the USA, the feeling grew within the Community that European strategy should be to develop a European currency. Along with the dollar, such a currency could be used both as a trading and as a reserve currency in the international economy. It would not necessarily be rigidly fixed in terms of the dollar.

The changed mood of the European central banks can be traced largely to their increasing impatience with their obligation to absorb large quantities of dollars into official coffers, and to their inability to check the spectacular rise of interest rates in the Eurodollar market under the impact of huge American borrowings.

The unique position of the dollar as the main currency of intervention in exchange markets made it necessary for the central banks of the Community nations to purchase any overflow of dollars in their markets to the extent necessary to prevent the dollar's price from falling more than 0·75 per cent below IMF par values.

This obligation was limitless and unconditional under existing arrangements. It was agreed to at a time when the dollars so acquired could always be converted, without question, into gold at the US Treasury. The United States' persistent payments imbalance thus confronted the EEC surplus countries with the choice of either financing US deficits indefinitely – whether or not they agreed with US policies – or appreciating their currencies in terms of the dollar, as happened in May 1971 when the German mark and the Dutch guilder were allowed to float.

Such appreciation by countries acting in isolation raises the costs of their producers in relation to the costs of their competitors in all other countries which do not appreciate their own currencies simultaneously. Even governments of countries whose currencies are not overvalued are reluctant to impose such a decision upon their farmers and industrialists, and thus weaken their competitive position throughout the world.

The American Government's decision on August 15, 1971, to suspend the convertibility of dollars into gold, and the devaluation of the dollar and the realignment of exchange rates in December 1971, gave impetus to the move for a reform of the world's monetary system. Following the return to fixed exchange rates, though within wider margins, Community member states in March 1972 resumed their advance to economic and monetary union.

The Werner and other plans for monetary union

The first Barre Plan, a Commission memorandum submitted to the Council in February 1969, called for coordination of economic policies and monetary cooperation within the Community. It said that the member states should concert medium-term and short-term economic policies, and set up Community machinery for monetary cooperation: short-term and medium-term mechanisms for mutual financial assistance for member countries with balance of payments problems.

The second Barre Plan, submitted in December 1969, envisaged a three-stage process leading to economic and monetary union by 1978, it again advocated that the six member countries should gradually coordinate their economic monetary policies, harmonize their taxes, narrow exchange rate margins, and establish a Community capital market and a mutual balance-of-payments assistance mechanism.

The memorandum urged the six member states to act as a unit in international monetary organizations and to abstain from widening exchange rate margins between their currencies. In the final stage, Community institutions should have the powers necessary to ensure the smooth functioning of the union. Member states should prepare to introduce a Community system of central banks and a European reserve fund. They should set unalterable exchange rates between their own currencies, establish free movement of capital, and eliminate fiscal frontiers. The memorandum concluded: "The conditions governing the introduction of a single European currency would then be fulfilled."

In addition to the Commission's proposals, various member states submitted plans. While there were differences in emphasis, the general aims resembled those outlined by the Commission. Germany, for example, called for completely stable and guaranteed exchange rates between member states, but stressed that any move to a common reserve fund must be preceded by a prolonged process of economic and monetary coordination and harmonization. Transition from one stage to another should not be automatic, but dependent on a decision of the Council of Ministers.

The Werner Report's proposals

The Council's agreement of February 1971 on economic and monetary union is based largely, though not exclusively, on the proposals suggested by a group of experts headed by Luxembourg Premier Pierre Werner. The interim and final Werner Plans, in turn, were influenced by the Commission's Barre Plans and the various national proposals.

The Werner Report described the measures that the Six would have to take to reach an economic and monetary union, and the consequences that would result from its achievement. It suggested that a first three-year stage commence on January 1, 1971.

These would be the main consequences of such a union:

1. Community currencies would be freely convertible among one another, and their parities *vis-à-vis* one another irrevocably fixed. It would be preferable if they could be replaced by a single Community currency.
2. The creation of liquidity in the entire Community, and monetary and credit policies, would be centralized.
3. There would be a Community monetary policy *vis-à-vis* the rest of the world.
4. Member states would unify their policies on capital markets.
5. The main components of budget policy – especially their volume, and the size of the budget surplus or deficit and the means of using the surplus or financing the deficit – would be decided at Community level.
6. Regional and structural policies would no longer be exclusively the domain of member states.
7. Trade unions and employers' organizations would be systematically and continuously consulted at Community level.

As a result of these steps, the accomplishment of economic and monetary union would require the creation or the transformation of a number of Community organs, to which certain functions hitherto exercised by national authorities would have to be transferred. The Werner Report said that these transfers of responsibility would represent a process of fundamental political significance, implying the progressive development of political cooperation. Economic and monetary union would thus appear as an unavoidable stimulus to political union in the long run.

Two bodies

In the final stages (i.e. after 1980) two Community bodies would be indispensable:

- a decision-taking centre for economic policy, which could influence national budgets, decide to change the parity of the single currency or the Community currencies as a whole, and be responsible for the other sectors of economic and social policies that had been transferred to a Community-level.

This organ would be politically responsible to the European Parliament, whose statute would have to be modified – to increase its powers and amend the way its members were elected – to correspond with the Community's extended role.

- A Community central-bank system, which would be empowered to decide on internal monetary policy (liquidity, interest rates, the granting of loans to the public and private sectors). In the field of external monetary policy this institution would have competence over exchange markets and the management of the Community's monetary reserves.

As the Community advanced towards monetary union, Community bodies would be created to take over or complement the role of national bodies. This would ultimately involve the amendments of the Rome Treaty. In all sectors, the measures that had to be taken would be interdependent and would reinforce one another. In particular, the development of monetary unification would have to be linked to parallel progress in the field of the convergence, and then the unification, of economic policies.

First stage, 1971-73

The Werner Committee said that it did not seem possible at that stage to lay down a precise and rigid timetable. A certain flexibility was necessary to allow for adaptations suggested by experience gained during the first stage.

The first stage would begin on January 1, 1971, and last for three years. One of the main aims to be attained during the first stage would be the development of a swift, mutual information system which would enable the joint drafting of basic guideposts for economic and monetary policy.

The coordination of economic policies would have to be based on at least three reviews in depth a year of the economic situation in the Community, so that jointly prepared guidelines could be laid down. During a first meeting in the spring the authorities would review the past year's economic policy and adapt it to any economic changes. At a second, mid-year review, they would work out the initial guidelines for the following year's policy and decide on the policy to be followed during the remainder of the current year.

During the third review, in the autumn, the authorities would draw up mutually compatible budgets. The indicators set in the budgets would serve as guidelines for the authorities responsible for deciding on monetary policy and credit. During this third meeting, the Council of Ministers would draw up, on the basis of a Commission proposal, an annual report on the Community's economic situation, indicating in particular the short-term economic policy guideposts for the following year. If a member state or the Commission requested it, *ad hoc* discussions could recommend specific actions.

During the first stage, the Council of Ministers would be the central decision-taking body for general economic policy. It would set the medium-term goals and, within that framework, decide on annual action programmes. The competent Commission members and the Central-Bank Governors would take part in these Council meetings. In addition, the Council would have the power to convene rapidly top-level representatives of governments and central banks who would have enough responsibility to enable decisions to be taken.

It would be for the Commission, within the framework of the powers accorded it by the Community Treaties, to submit to the Council any appropriate proposal so that the Ministers could act on the matter in question. The various Community Committees responsible for economic policy would also play a greater role. The Committee of Central Bank Governors would assume an increasingly important part in determining the Community's internal and external monetary policy.

Annual report

To ensure a better coordination of economic policies, the annual report on the Community's economic situation would be presented to the European Parliament and the Economic and Social Committee; and member governments would present it to national parliaments so that they could bear it in mind when discussing national draft budgets. There would be a similar procedure for the medium-term quantitative goals set at Community level. Before the adoption of the major guidelines of a Community-level economic policy, the Commission would consult trade-union and employers' representatives, according to procedures to be worked out.

Member states' budgetary policies would be carried out in relation to Community goals. There would be a Community review before governments took the final decision on their draft budgets. National budget procedures would be synchronized. Taxes would be harmonized as necessary, so that tax frontiers in the Community could be gradually and completely abolished.

Remaining obstacles to the freedom of capital movements, and especially exchange controls, would have to be rapidly eliminated. The authorities would also have to coordinate their policies on capital markets to remove inequalities in the cost and conditions of access to credit.

To strengthen the solidarity of the Community's foreign-reserves system, the Werner Committee called on the Community's central banks to limit fluctuations between member states' exchange rates. This should commence on January 1, 1971, on an experimental basis.

If the technique were successful, margins could be further narrowed, and a *de facto* situation could be changed into a *de jure* one. The authorities should study the creation and operation, as well as the possible statute, of a European fund for monetary cooperation; this institution would have the task of supervising the transition to a Community central-bank system, envisaged for the final phase.

The Werner Committee recommended that before the end of 1973 an inter-governmental conference be held to decide on the amendments that would have to be made to the Rome Treaty to provide the necessary legal basis for the change-over to an economic and monetary union. A special Council session would then work out an action programme for the following years.

The Commission's proposals based on the Werner Report

After studying the Werner Report, the Commission in October 1970 forwarded to the Council a memorandum expressing its views on the Werner Group's findings. This memorandum was accompanied by a draft resolution calling for the implementation of the first stage of an economic and monetary union, a proposal for a Council decision on the strengthening of the coordination of member states' short-term policies, and a draft Council decision on increased cooperation between the central banks of the Six.

The Commission memorandum shared the views expressed in the Werner Report on the factors indispensable to the existence of an economic and monetary union and on the economic consequences implied by such a union.

It stated that the prospect opened up in The Hague by the heads of state or government was of fundamental political importance for the Community. The establishment of economic and monetary union would also lead to progress in the field of political unification, and bring other benefits.

The Commission considered that the achievement of economic union and monetary union would have to be accompanied by the transfer to the Community of certain powers previously exercised at national level. Such transfers should be limited to what was necessary for the cohesion of the union and for the effectiveness of Community action; and policies decided on at Community level would have to be subject to democratic control by the European Parliament. They would require regular consultations with both management and labour.

The Werner Report found that two organs would be indispensable to master economic and monetary policy within the union: a decision-making centre for economic policy and a Community system for the central banks. In both cases, the report limited itself to general guidelines and stressed the need for further, more detailed, study. The Commission noted that each of the two cases raised a different type of problem. On the one hand there were the problems of administering the monetary side of the union, where, among other things, the institution of a Community system for the central banks would be necessary.

On the other hand, there was the question of how the economic and monetary policy of the union was to be directed. In this respect, the Commission felt that the real problem was the transfer of the necessary powers and responsibilities to the Community institutions. It was impossible at present to prejudge how powers would be divided between the Community institutions, on the one hand, and between these and the national authorities of the member states, on the other. The Community institutions must in any case be in a position to work effectively and on a genuine democratic foundation.

Exchange rates

On the first stage of the transitional process, the Commission agreed in general with the conclusions of the report. It considered that the methods recommended for strengthening coordination of short-term economic policies represented the first step along the road towards the final objective in this field. It attached special importance to the view expressed in the report on the gradual reduction of the range of fluctuation of currency-exchange rates between member countries, and to the recommendations made on the basis of the studies carried out by the Committee of Central Bank Governors.

However, it stressed that structural and regional measures should occupy a more important position in the description of what was to happen in the first stage. These measures should be put in hand without delay in the Community in order to reduce the strains which might compromise the eventual establishment of economic and monetary union.

The Commission did not believe it possible to make any detailed observations on the short section of the report dealing with the transition towards the final objective. For this purpose it planned to set up a "European fund for monetary cooperation" during the second stage and, if certain conditions were fulfilled, "it may well be possible to establish the fund in the course of the first stage". The Commission felt that this important question deserved closer examination, which should be undertaken without delay on the basis of the report of the Committee of Central Bank Governors.

The Commission proposed to the Council that by December 31, 1970, it:

- Resolve to establish by stages an economic and monetary union in the Community, in which the Council would express its political will to reach this goal during the present decade, and would, for the period 1971-73, adopt an action programme as a first stage in the overall process of achieving economic and monetary union.
- Decide to strengthen coordination of short-term economic policies; and bring about closer cooperation between the central banks of the Community countries. By these decisions the Council would launch the action programme.

Agreement on a phased programme

The idea of an economic and monetary union was first put forward in the memorandum of February 1968 from the Commission to the Council of Ministers, drafted under the supervision of Commission Vice-President Raymond Barre. At the request of the Council, the idea was further developed in a second Commission memorandum dated February 1969. These became known as the two Barre Plans. After debate in the Council of Ministers, the national political authorities were asked to examine the idea in an *ad hoc* committee, chaired by Luxembourg Prime Minister and Finance Minister Pierre Werner. The committee presented an interim report in June 1970, and its final report to the Council in October 1970; and on the basis of both Barre Reports and both Werner Reports, the Commission on October 30, 1970, submitted to the Council the formal proposal for economic and monetary union.

In the process of submitting a radical idea to the scrutiny of sovereign states, surprisingly little of the original plan was lost. Indeed, its main components remained intact.

The transfer of certain precise powers to a common institution had been strongly recommended in both the Barre and the Werner Reports. The decisive agreement of February 1971 by the Council of Ministers did not in itself achieve this transfer, but it went some way towards giving a degree of common direction to one instrument, monetary policy, by increasing the powers of the Committee of Central Bank Governors; this body was not mentioned in the Common Market Treaty and came into existence six years after the Common Market began operating.

The other main economic instrument, fiscal policy, remains largely in the hands of the member governments. While no outright deletions were made from the original tax harmonization proposals contained in the Barre Plans, the Werner Reports, and the Commission's formal proposal, some specific recommendations were made more abstract, or less compelling. Thus, for example, the Council resolution commits the member states to harmonizing the base and scope of excise duties, but not to achieving uniform rates, as the Commission had proposed. Or, the Council resolution commits the Six to "further harmonization of the structure of company taxation", rather than to the harmonization of the base, as proposed by the Commission. The Six did, however, renew their commitment to achieving a uniform turnover tax system for the value-added tax (VAT), which in Europe is a large source of tax revenue for the national governments, and could eventually become one for the Community itself. Beginning in 1975, up to the equivalent of a 1 per cent VAT rate could accrue to the Community's coffers to help pay for Community policies.

Principles

In June 1970 the Council adopted the conclusions in the Werner group's preliminary report. These were that:

- An economic and monetary union could be attained during this decade, if the plan had the permanent political support of the member governments;
- An economic and monetary union would mean that the main economic policy decisions would be taken at Community level and therefore that the necessary powers should be transferred from national to Community level. It could result in the adoption of a single currency which would guarantee the irreversibility of the undertaking;
- Some of the measures that would be necessary would involve the amendment of the Rome Treaty and the preparation for this should be made from the first phase. However, the present Treaty provisions allowed for substantial progress;
- The first phase should begin on January 1, 1971, and could technically be completed within three years. This phase would be used to make the Community instruments more operational and to mark the beginnings of the Community's individuality within the international monetary system;
- The first phase should not be considered as an objective in itself; it should be associated with the complete process of economic and monetary integration. It should therefore be launched with the determination to arrive at the final goal;
- In the first phase consultation procedures should be strengthened; the budgetary policies of the member states should accord with Community objectives; some taxes should be harmonized; monetary and credit policies should be coordinated; and integration of financial markets should be intensified;
- The Community should gradually adopt a common line in its monetary relations with non-member countries and international organizations; in particular, it should not make exchange rates between member countries more flexible, even if this happened in the international exchange-rate system.

Goals for 1980

By 1980 the Community would, according to the Council resolution:

1. Constitute a zone where persons, goods, services and capital would move freely – but without distorting competition, or creating structural and regional imbalances – and where economic undertakings could develop their activities on a Community scale;
2. Form a single monetary entity within the international monetary system, characterized by the total and irreversible convertibility of currencies; the elimination of fluctuation margins of exchange rates between the Six; the irrevocable fixing of their parity relationships. These steps would be essential for the creation of a single currency, and they would involve a Community-level organization of central banks;
3. Hold the powers and responsibilities in the economic and monetary field that would enable its institutions to ensure the administration of the economic union. To this end, the necessary economic policy decisions would be taken at Community level and the necessary powers would be attributed to Community institutions. The distribution of powers and responsibilities among the Community institutions, on the one hand, and the member states, on the other, would be in line with the need for cohesion of the union and the effectiveness of Community action.

The Community institutions would need to exercise their responsibilities in economic and monetary matters effectively and quickly. The Community policies carried out in the framework of the economic and monetary union would be subject to the control of the European Parliament. The Community organization of central banks would assist, in the framework of its own responsibilities, in achieving the objectives of stability and growth in the Community.

These three principles would apply to:

- The internal monetary and credit policies of the union;
- Monetary policy *vis-à-vis* the rest of the world;
- Policy on a unified capital market and capital movements to and from non-member countries;
- Budgetary and taxation policies, as related to the policy for stability and growth. (For budgetary policy, the margins within which essential elements of all public budgets must be situated, especially the variation in their volumes, the size of the balances, and the methods of financing deficits and using surpluses, would be determined at Community level).

• Structural and regional action needed to contribute to the balanced development of the Community.

As progress was made in moving closer to the final objective, Community instruments would be created whenever they seemed necessary to replace or complement the action of national instruments. All actions would be interdependent; in particular, the development of monetary unification would be backed by parallel progress in the convergence, and then the unification, of economic policies.

First phase

The Council in February 1971 agreed on a series of actions to be carried out during a first phase covering the three years 1971-73.

The Council fixes, at the Commission's proposal, provisions to strengthen the coordination of short-term economic policies, and in particular to achieve a greater degree of obligatory prior consultation. Coordination of short-term economic policies is related to programmes for medium-term economic policy.

After the Commission has consulted employers and unions, in the framework of the Economic and Social Committee or by other procedures, the Council lays down, at the Commission's proposal, the broad lines of economic policy at Community level and quantitative guidelines for the main elements of national budgets.

To facilitate coordination of economic policies, the Council, at the Commission's proposal and after consulting the Community Committees concerned, takes the measures needed to harmonize gradually the instruments of economic policy and especially the timetable for national budgetary procedures.

To speed up the effective freedom of movement of persons, goods, services and capital, and the interpenetration of national economies, the Council, at the Commission's proposal, enacts measures on:

• Community rules laying down a uniform basis of assessment of value-added tax (VAT);

• Harmonization of the field of application, the basis of assessment and the terms of levying of excise duties, especially those that considerably influence trade;

• Harmonization of taxes that directly influence capital movements within the Community, expecially taxes on interest from fixed-income stocks and shares and on dividends;

• Further harmonization of the structure of corporation taxes;

• The gradual enlargement of tax exemptions for individuals crossing intra-Community frontiers.

Before the end of the first phase, the Council will examine the studies undertaken, and the Commission's proposals, on the harmonization of VAT and excise duties.

To encourage the unrestricted movement of capital, the Council, at the Commission's proposal, plans, in the first phase, to:

• Adopt a directive authorizing the elimination of discrimination when stocks and shares are issued by someone who resides in another member country;

• Establish a procedure for the gradual coordination of member states' policies on financial markets.

• Take regional and structural action to reduce pressures which could compromise the achievement, on schedule, of the economic and monetary union. At the Commission's proposal, the Council will enact the measures necessary to solve urgent regional problems. These will be based on the Third Programme for Medium-term Economic Policy, and the Council will give the Community the appropriate means within the framework of the existing Treaties.

Short-term monetary aid

The Community member states' five central banks (Luxembourg and Belgium share the same central bank) on February 9, 1970, made $2,000 million available as short-term monetary aid to member countries running temporary balance-of-payments deficits.

Drawings from a first $1,000 million tranche are immediate and automatic upon request. From this first tranche, each member's central bank may draw up to the amount of its quota or pledge: Germany and France, $300 million each; Italy, $200 million; the Netherlands and the Belgium-Luxembourg Economic Union, $100 million each. The borrowing must be repaid in three months; and, after using the funds, the borrower must enter into economic consultations with the other member countries.

Borrowing from the second $1,000 million tranche is not automatic but requires prior economic consultation. However, a country can borrow up to the full $1,000 million. The loan from the second tranche, repayable within three months (but renewable), can be used either concurrently with the funds from the first $1,000 million, or consecutively. (A member country could, for example, first borrow $300 million, pay it back in three months, and borrow $1,000 million for another three months; or borrow a full $1,300 million at one time.)

The plan operates through the Bank for International Settlements in Basle.

Medium-term monetary aid

The Council decided on February 9, 1971, to set up machinery for medium-term financial aid. It provides that when a member state is faced with balance-of-payments difficulties or serious threats of such difficulties, it may resort to the machinery for mutual Community aid.

The granting of such credit is decided by the Council, acting by a qualified majority. Member states may be called upon to contribute up to the following ceilings:

	$ millions	%
Germany	600	30
Belgium/Luxembourg	200	10
France	600	30
Italy	400	20
Netherlands	200	10
Total	2,000	100

The system applies for four years as from January 1, 1972, with, in principle, automatic renewal every five years thereafter. These arrangements complement the short-term monetary support system which came into force in February 1970. The maximum quotas are identical under both systems.

Credits granted under the medium-term aid system are for two to five years. They are financed by the participating states in proportion to their uncommitted contributions. Normally, interest rates are about halfway between International Monetary Fund (IMF) and market rates.

A decision to grant aid lays down the amount and terms of the credit, and the economic-policy commitments to be undertaken by the recipient member state, particularly in relation to the quantitative guidelines for medium-term economic policy.

A member state claiming present or foreseeable balance-of-payments difficulties and/or a persistent fall in its reserves is exempted from subscribing to the scheme, but its economy remains under the Monetary Committee's scrutiny. If the Commission or a member state believes that the grounds for such exemption no longer exist, the Council may ask the member state concerned to take part in the scheme, and may lay down the terms for this.

The Council has agreed on the conditions and procedures for anticipated repayment of debts, total or partial, if the reasons for the initial appeal for aid have disappeared.

Member countries in balance-of-payments difficulties have to consult their partners before seeking medium-term loans outside the Community. The Monetary Committee then looks into the possibility of implementing the Community aid system, and examines the need for cooperation with the IMF.

Credit is mobilized either by credit transfers inside the system, by accelerated repayments by debtor countries, by refinancing outside the system, or a combination of all three. Refinancing might be arranged through a joint Community approach to international organizations, like the IMF.

Coordination of monetary and credit policies

To strengthen the coordination of monetary and credit policies, the Council agreed that:

- Prior and obligatory consultations should be intensified within the Monetary Committee and the Committee of Governors of Central Banks;
- The central banks, within the limits of their competences and within the framework of their own responsibilities, should coordinate their policies within the Committee of Central Bank Governors, on the basis of the general economic policy as set out by the Council;
- The Monetary Committee and the Committee of Central Bank Governors should continue to cooperate on the harmonization of monetary policy instruments.

The Council decided that the Community should gradually adopt a common stand in monetary relations with non-member countries and international organizations; in particular, it should not make exchange relations between member countries more flexible.

From the beginning of the first phase, and on an experimental basis, the central banks should keep the fluctuations of rates between Community currencies within narrower margins than those resulting from the application of the margins in force for the US dollar.

Depending on the results in the harmonization of economic policies, new measures could be taken to move from a *de facto* to a *de jure* system of intervention in Community currencies. The Committee of Central Bank Governors must report twice a year to the Council and the Commission on the functioning of the concerted action of the central banks on the exchange markets, and on the advisability of adopting new measures in this field.

Coordination of short-term economic policies

Member states coordinate their monetary and their credit policies within the terms of the Council's guidelines for general economic policy. The EEC central banks coordinate, within the Committee of Governors, their monetary and credit policies; draw up general guidelines to be followed by each bank, particularly on bank liquidity trends, loan terms, and interest-rate levels; and work out the means for applying this procedure.

The Council meets three times each year to review the Community economy. On the basis of a Commission report and, where appropriate, draft decisions, directives or recommendations proposed by the Commission, the Council enacts guidelines for the short-term economic policy to be followed by the Community and by each member state so as to ensure balanced growth.

At the first meeting, the governments review the previous year's economic policy. At a second examination they draw up compatible guidelines for the main features of the preliminary budgets for the following year. Quantitative guidelines for these draft budgets are then finally adopted. These guidelines take into account proposed increases or decreases in expenditure, and deal with the methods of financing deficits or using surpluses.

At the third meeting, the Council, on a proposal from the Commission and after consulting the European Parliament, adopts an annual report on the Community's economy. This enables member governments to fix the economic guidelines that each member state should follow in the subsequent year.

After its adoption, each member government submits this annual report to its national parliament for debate.

In October 1971, the Council for the first time carried out this section of the plan, when it adopted an annual report on guidelines for 1972.

Beyond the first stage

By June 30, 1972, the Monetary Committee and the Committee of Central Bank Governors must jointly report to the Council and Commission on the organization, functions and statutes of a European Monetary Cooperation Fund. The Fund could be integrated later in the Community organization of central banks. Depending on experience acquired in reducing margins and harmonizing economic policies, this Fund should be established during the first phase.

To ensure the necessary parallelism between the economic and monetary measures, the monetary provisions (narrowing of margins, and the creation of a European Monetary Cooperation Fund) and the medium-term financial assistance mechanism are valid for five years as from the beginning of the first phase. Should agreement be reached on the transition to the second phase, these provisions will remain in force.

By May 1, 1973, the Commission should submit:

• a progress report on the first phase taking into account the parallelism needed between coordination of economic policies and progress in the monetary field in the Community;

• a report, drawn up in collaboration with the advisory committees concerned, on the distribution between the institutions of the Community and the member states of powers and responsibilities required in carrying out short-term economic policy, monetary and credit policies, and budgetary policy, if the economic and monetary union is to work effectively.

Before the end of the first three-year phase, the Six will lay down, at the Commission's proposal, the measures leading, after the transition to the second phase, to the complete achievement of economic and monetary union. These will be based on the existing provisions of the Treaty, or on articles 235 or 236 of the Treaty. (These permit the member states to take unanimous action to achieve Community goals where this is not allowed for in the Rome Treaty, or to amend the Treaty).

Third medium-term economic policy programme (1971-75)

The member states on February 9, 1971, also adopted the Community's third medium-term economic policy programme, for 1971-75. This programme, based on a draft submitted by the Commission, contained for the first time compatible statistical guidelines for 1971-75 and defined the overall economic policies and major structural projects which would have to be carried out at both national and Community levels.

The programme was the Community's third and by far the most ambitious; it was the first to set quantified guidelines for four key economic indicators – movement of prices, level of unemployment, rates of growth (gross national product), and the balance-of-payments – and to ask the member states to conform to them.

The plan put special emphasis on prices, saying Germany and France had a vital role to play in ensuring that their prices and economies did not get as far out of line as they did in the late 1960s, forcing both countries to change their currency parities in opposite directions. Comparing the increases forecast in the various countries' national plans for the next five years, the Commission said "the projections made by the member states seem to verge on incompatibility".

The Commission sought to bring the inflation rates more into line and set targets agreed on by all the members of the Medium-Term Economic Policy Committee and the Commission (which was represented on the Committee). In some cases, this meant a change from the national plans as originally drafted.

Over 1971-75, the Community should seek an average annual price increase growth of 2·5 to 3 per cent, if measured on the global index of all items included in the gross national product, or between 2·3 and 2·8 per cent if measured on the consumer price index.

Unemployment targets set for 1971-75 ranged from 0·8 per cent for Germany to 3 per cent for Italy. The Commission said its unemployment figures should not be taken as an objective, nor as a minimum. They simply reflected the employment levels that would be considered satisfactory.

For growth of member states' gross national products (the total output of goods and services), the Commission called for an average of 5 to 5·5 per cent a year, excluding price increases. France was expected to grow a little more than average and Germany a little less. For Belgium and Luxembourg, the guidelines in the Community programme have ranges somewhat lower than those aimed at in their national plans.

Looking to their balances of payments, the member states worked out forecasts for two measures:

• the so-called external balance, which covers not only payments for goods and services, but also other items, such as immigrants' remittances, which are not pure capital transactions;

• the current account balance, which covers day-to-day payments for trade in goods and services.

The external balance was forecast to average one per cent of the Community's gross national products over the five years, while the surplus on current account was put at 0·3 per cent of GNP. Germany was expected to have the biggest surplus – 1·7 per cent in its external balance, while France's would be exactly the Community average. On current account, most members were expected to come close to breaking even; Italy and the Netherlands were the exceptions.

Taking the first steps

In March 1972, after almost a year's halt, the Community resumed its advance to economic and monetary union. The Six – and the four prospective member states – resolved to:

• Strengthen the prior consultation procedure agreed in July 1969, and ensure that member governments consult their partners before deviating from agreed economic policies;

• Set up a top-level Council working party to coordinate short-term economic and financial policies within guidelines laid down by the Council;

• Narrow fluctuations in the exchange rate between Community currencies – on an experimental basis – from the present maximum of 4·5 to 2·25 per cent, and gradually eliminate them later;

• Promote stability, growth and full employment in the Community, on the basis of a Commission draft directive;

• Use Community funds to step up development of backward regions;

• Act jointly to counteract sudden large inflows of capital from outside the Community;

• Give priority to Commission proposals on tax harmonization and the freeing of capital movements.

Ministers reached the agreement in principle on March 7, 1972, and formally adopted it at a Council session on March 20-21, after the applicant countries had accepted the plan in principle.

Britain, however, made three points:

• The 2·25 per cent band should not be narrowed if, on the day the measure were introduced, Community currencies should be even closer together;

• Intervention within the Community and the wider international band should be concerted;

• Community central banks should settle their accounts in proportion to the debtor country's reserves.

Britain attached importance to the regional aspects of the agreement and said that regional aid should be given to declining industries.

EEC monetary zone

The agreement is seen as a vital move in consolidating the Community and paving the way for further integration. The measures are regarded as a first step in the formation of a distinct European monetary zone, which could help to stabilize international monetary relations. As they are carried out they will have direct implications for the Community's tax systems, agriculture, capital markets, and regional development; they will have political consequences, in that control of economic and monetary policy will gradually be transferred from the national to the Community level. By acknowledging the need for Community action to help backward regions, member states have accepted further financial solidarity, which should also strengthen political cohesion.

The basic decisions on creating an economic and monetary union had been taken in February and March 1971. Apart from coordination of budgetary policies, however, the plan remained virtually stillborn. The Six were about to take the first concrete step in June 1971, narrowing exchange-rate margins between their currencies; then the world monetary crisis led Germany and the Netherlands on May 10 to float their currencies. President Nixon's economic package of August 15 – especially the decision to suspend the convertibility of the dollar into gold – led to further monetary disarray, with member states adopting various policies: floating rates, wider margins, and the "two-tier" system for capital and trade transactions.

Mean parities

In the world currency realignment of December 1971, the central feature was an 8·57 per cent devaluation of the dollar in terms of gold. This restored mean or "central" (though not fixed) parities for exchange rates; but at the same time the official margin of fluctuation against the dollar was widened to 2·25 per cent on either side of the central rate. Thus the maximum fluctuation in terms of the dollar was twice 2·25 per cent – 4·50 per cent.

The paradox of the new situation, however, was that the theoretical possible fluctuation for Community currencies against each other now stood at twice 4·50 per cent – 9 per cent – a level hardly compatible with the notion of stable trading conditions in a single market without trade barriers. It was even less compatible with the notion of free trade in farm produce, based on prices fixed in terms of gold. Moreover, with an inconvertible dollar still the currency of interventions in foreign-exchange markets, central-bank intervention to stop its currency going through the ceiling would mean a further accumulation of dollars which might later have to be unloaded at a loss. In this situation, with central banks unwilling to acquire dollars, the likelihood of wide fluctuations between Community countries' currencies themselves was substantially greater than before the crisis.

Member states felt that their economies were linked too closely to the fortunes of the dollar and that they still risked being submerged by a massive inflow of dollars. Community central banks could be forced to buy up the dollars, to maintain their parity, or let the dollar rate depreciate even further, thereby making Community goods less competitive with US exports on world markets.

Member governments therefore had a powerful incentive to agree swiftly on a set of new economic and monetary measures. The measures agreed on in March 1972 were based to a large extent on the Commission's proposals, and the Commission played a major role in enabling the Six to make concessions to each other and so reach a common stand. It was France in particular that urged a smaller currency fluctuation band, largely because currency fluctuations disturb the operation of the common agricultural policy (see page 6).

Farm prices

Whenever Community parities have changed their relationship to one another by more than 2·5 per cent the Community has, under arrangements agreed by the Six, introduced border taxes and rebates to neutralize the effect of these fluctuations on food prices. For example, the revaluation of the mark meant that, though German farmers received the same number of units of account, this was equivalent to fewer marks. Imports from partner states were therefore taxed at the German border to bring their price up to the previous level in terms of marks.

Germany, backed by the Netherlands, argued that as their currencies were the strongest in the Six, their central banks might well have to bear the main burden in keeping weaker currencies within the narrower band. They therefore sought parallel moves to coordinate member states' economic policies. Here, France accepted Germany's views on the creation of a high-level steering committee and obligatory prior consultation. It is understood, however, that in emergencies governments may act first and seek approval from their partners afterwards.

Italy, supported by Belgium, called for parallel Community action in bolstering up poorer areas of the Community. By committing themselves to closer coordination of monetary and economic policies, member governments could have less room for manoeuvre in national action and at the same time may need to increase outlays to promote balanced development. Britain, Norway and Ireland are understood to share the Italian view; of the Ten, these four countries have the most serious regional problems and therefore stand to gain most from any allocation of Community funds. Under discussion are the annual provision of 50 million units of account from the European Agricultural Fund to encourage firms to set up factories in declining agricultural regions, and the creation of a regional development fund, which would each year pump a further 50m units into distressed regions, in the form of capital grants and interest subsidies on loans.

Capital flows

To help to stabilize the Community's own exchange system and to neutralize the effects on internal liquidity of sudden large movements of short-term capital from outside, the Council adopted the Commission's draft directive of June 23, 1971. This includes measures to: regulate deposits in the money market and the interest paid to non-residents; control loans which Community residents contract in non-Community countries; regulate the net external liabilities of credit institutions; and fix compulsory reserve margins, particularly for non-residents' assets. Here, Germany had been reluctant to limit her freedom of action.

Both Germany and France were unwilling to commit themselves at this stage on the proposed establishment of a European monetary cooperation fund. Such an institution presupposes far-reaching integration of monetary policies and would represent a major advance to a Community central bank system and a pooling of reserves. The Six therefore repeated their 1971 decision that experts submit a report on such a body by June 30, 1972.

As essential complementary measures, the Council also agreed to tackle urgently the Commission's proposals to ease the circulation of capital within the Community and establish a European capital market, and to harmonize taxation. The Council's resolution does not, however, refer to the Commission's related proposal for intensified social measures to employ, train and retrain workers.

On taxation, the main proposals involve: a uniform basis for assessing value-added tax; harmonized taxes on fixed-interest stocks, shares and dividends (these directly influence capital movements in the Community); further harmonization of the corporation-tax structure; and larger tax exemptions for tourists travelling between Community countries.

To facilitate capital movements, the Commission seeks a coordination of national policies on capital markets and abolition of discrimination when a firm in one member country issues stocks and shares in another country.

Most of the March 1972 decisions resemble those taken in 1971 on the first stage (1971-73) of economic and monetary union; the Six then agreed on closer coordination of, and prior consultation on, financial, budgetary and economic policies; tax harmonization; and easier capital movements. The major exception is the setting up of the steering committee. The Six had, however, planned to narrow on June 15, 1971 the margin of fluctuation between Community currencies from 0·75 to 0·60 per cent either side of dollar parity. (Under IMF rules the margin either side was 1 per cent, but under an OECD European Payments Union agreement, European countries in practice set their intervention points at about 0·75 per cent either side of par).

Maintaining narrower margins

The fluctuation margin is a device which allows currencies to enjoy some of the flexibility of a floating exchange rate with the security of a fixed rate. Before May 1971, for example, each currency was pegged by a specific rate to the dollar and thus to all other currencies. The rate was changeable only by devaluation, revaluation or a temporary float. But a fluctuation margin of 1·5 per cent (0·75 per cent up and 0·75 per cent down) was put around the fixed rate with the dollar so that currencies could move slightly to absorb exchange market pressures. After the world monetary upheavals of recent years, however, this band was considered too narrow, and in December 1971 the ten richest nations decided to widen it to 4·5 per cent (2·25 per cent above and 2·25 per cent below) the central rate.

Whenever a country's currency is weak *vis-a-vis* the dollar, that country's bank sells dollars to buy its own currency, in order to bring its currency nearer the parity rate. When the country's currency is strong, its central bank has to sell its currency and buy dollars, to reach parity. In recent years, the dollar has been weak and most Community countries' currencies have been strong. Community central banks have therefore been obliged to mop up large quantities of dollars – an arrangement which has discriminated in favour of the dollar. Until the US had suspended the convertibility of the dollar on August 15, 1971, central banks could theoretically swap their dollars for gold, though they did not always do, partly because this would have further weakened the dollar.

Normally the currencies float according to market pressures inside the band with little intervention, but in a crisis very large amounts are bought and sold. Up to now the European central banks have not in general intervened in other Community currencies against each other in this system, because their exchange relationships have derived from their respective dollar relationships.

Disadvantages for Europe

A further feature discriminating in favour of the dollar was that the exchange rate between two European currencies – the "cross rate" – could vary by twice as much as the rate of each against the dollar. If one day the mark stood at the dollar ceiling and the lire at the dollar floor and the next day the positions were reversed, the actual change on the market between the two would be 9 per cent – assuming the present 4·5 per cent band.

Thus Community currencies had been able to fluctuate by 2·25 per cent either side of the normal rate for the dollar, i.e. by 4·50 per cent against the dollar but by 9 per cent against one another over a period.

In practice such a rapid shift does not happen, but over a period of months it is possible. Therefore businessmen prefer to make long-term contracts in dollars because its relation to any other currency cannot change by more than 4·5 per cent, barring revaluation or devaluation. The wide deviation which had been possible between European currencies could upset the Community's common market in farm products: without stable monetary relations, a complicated system of compensation must be operated at the border between member countries.

Therefore the Community's central banks have decided that from April 24, 1972 member states' currencies must not diverge at any given moment by more than 2·25 per cent from each other. Thus over a period they will not be able to fluctuate against each other by more than 4·50 per cent (by two currencies reversing their position in the 2·25 per cent band). This new narrow band has become known as the "snake" inside the "tunnel" of the global 4·5 per cent band. As long as market forces maintain the European currencies within 2·25 per cent of each other inside the tunnel, there will be no problem. The snake could be as thin as market forces permit. If, for example, all the currencies remained at the same rate against the dollar, the snake would simply be a single line on a chart. Ultimately the Community aims gradually to slim the permitted band to this point, and thus create a common European currency – at least for central-bank transactions.

But when the relationship between two Community currencies threatens to diverge beyond 2·25 per cent, problems will arise. Central banks of the two currencies will have to intervene in each other's money to ease the pressure. If, for example, the mark were at the upper limit and the lire at the lower, either the Banca d'Italia would borrow marks from the Bundesbank and use them to buy lire and support its sinking currency, or the Bundesbank would buy lire and sell marks. Which bank should bear the brunt of the intervention – that with the strong money or that with the weak – will be decided on a case-by-case basis.

Relation to the dollar

In principle, the Europeans would like the band, which can be narrower than 2·25 per cent but never wider, to move up and down in the tunnel according to market forces. When the Community currencies are very strong, the snake's top will touch the ceiling and the banks with the strongest currencies will buy dollars with their money as before to force their currencies down. Similarly, if the Community currencies become very weak and the snake hits the bottom, the banks with the weakest currencies will sell dollars and buy their own currency. The Commission has proposed a common fund to spread out the burden for the high or low currencies which must intervene in dollars, and the governments have asked their central banks to report on the proposal by June 30, 1972.

As the Europeans intervene in each other's currency they will inevitably run up debts. But they do not want to establish a precedent for holding each other's currencies, i.e. leaving debts unpaid too long, since if a currency is consistently strong and its bank keeps lending money to support others, it could become a sort of reserve currency with the headaches which that brings. Therefore it was decided to balance all debts once a month.

The bankers also frown on allowing debtors to make repayments in whatever form they wish, since the temptation to unload unwanted dollars in that way might be too great. Thus each country will pay its debts by a formula corresponding to the composition of its reserves. This way the reserve positions of the European countries should tend to align themselves.

Composition of reserves, March 1972 (percentages)

	Gold	Special Drawing Rights	Currencies (Dollars in brackets)
France	46	10	43 (41)
Netherlands	55	35	11 (5)
Belgium	48	31	21 (18)
Italy	46	9	45 (36)
Germany	23	8	67 (63)
UK	13	10	77 (mostly $)

One short-term advantage of narrower margins is that Community currencies will not be more than 2·25 per cent apart at any moment, and cannot fluctuate against each other by more than 4·5 per cent over time, instead of by 9 per cent, as formerly. This eliminates the discriminatory treatment favouring the dollar, increases stability in making Community payments and, on a political level, can be the start of a Community monetary system.

But it remains to be seen whether the new system will be able to withstand intense speculative pressure. If a member state changes the value of its currency through revaluation or devaluation (the Council's agreement does not exclude this), the system can theoretically absorb the change, since the fixed rate itself and not the margin is shifted. But if such a change is preceded by the usual period of hesitation, speculative movements could upset the mechanism used to preserve the narrow band. Member states have, however, adopted measures to control sudden inflows of short-term capital, which are intended to provide protection in such an event.

Another major problem could arise should one currency enter a chronic debtor situation, thereby draining its reserves. A number of devices exist to extend medium- and long-term credit; these include the Community's medium- and short-term financial aid systems, for each of which member states have made $2 billion available. Recourse to these, however, is not the same as correcting the situation. To achieve this, the chief weapon would be the measures adopted on economic coordination. Member states' ability to keep their economies in line is seen by many experts as the key to ensuring the success of the whole ambitious plan for economic and monetary union.