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Mr Potter
Page 4 exemplifies a strand of thinking on EMU here. While Govt want to extend Stage 2 and postpone Stage 3, there is a respectable argument for getting from 1 to 3 in the shortest possible time. AT 29/6

15 June 1990

Andrew Turnbull
10 Downing Street
London SW1

Dear Mr. Turnbull,

I thought you might be interested in the draft of a paper I will present to the French Treasury seminar on EMU next week. It will probably be amended in the light of the discussions and formally published in two to three weeks.

Yours sincerely.

Graham Bishop

Graham Bishop

I felt this follows on from our conversation a few weeks ago. Perhaps it would be useful to have a discussion after this seminar.

Ministere de l'Economie et des Finances

Colloque sur l'UEM

THE CREATION OF A EUROPEAN COMMUNITY "HARD MONEY" UNION

by

Graham Bishop
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21 June 1990

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THE CREATION OF A EUROPEAN COMMUNITY "HARD MONEY" UNION

Introduction

The creation of a successful European Community (EC) "hard money" union hinges on the control of public debt. In discussing monetary union, many commentators focus on the needs of the state that will issue the debt and pay little attention to the welfare of those who will purchase it. This report examines monetary union from the perspective of the electors who will be trying to preserve the value of their hard-earned savings by investing in public debt.

Savers are the owners of public debt, both directly and through the institutions that collect up the savings of the individuals of the Community and channel them into sound investments. The Single European Act, following from the spirit of the Treaty of Rome, specified free movement of capital and services. The financial part of the Single Market programme amounts to no more than governments trusting the people with their own money. There is a natural consequence: citizens will vote with their money more easily and continuously than they can "vote with their feet" - although in the Single Market they will also have the freedom to do that.

I believe strongly that, in a properly designed structure, investors can exert the necessary discipline on public debt. This discipline will show, initially, in a widening of the differential in the price of the debt of the deteriorating debtor compared with the European average. Then there is the inevitable, ultimate sanction of market discipline: the markets may no longer be willing to provide credit at any reasonable price.

A rigorous pursuit of this approach will have profound political implications, because it will make governments continuously accountable for their financial behaviour to their electorate. If citizens are indeed fit to be trusted with their own money, then democratic governments should willingly accept the verdict rather than try to create covert mechanisms to negate the electors' choice. That portion of the electorate who are also savers will notice a formal default on public debt, but creeping default - by inflation - escapes attention all too easily. 1989 witnessed a revolution in Eastern Europe as citizens struggled for democracy and economic freedom. 1990 sees Western Europe calling for democratic accountability to be enhanced within the EC. A "hard money" union will help provide this.

Our approach leads to the need for a set of rules for both the issuer and the investor, especially the financial institutions that are the intermediary for the bulk of savings. Neither group can be ignored, because they are simply the two sides of the same coin.

THE IMPACT OF SAVERS ON THE THREE STAGES OF MONETARY UNION

The principal features of a monetary union are straightforward and the Delors Committee Report restated the 1970 Werner Report's conditions:

- "the assurance of total and irreversible convertibility of currencies;
- "the complete liberalisation of capital transactions and full integration of banking and other financial markets; and
- "the elimination of margins of fluctuation and the irrevocable locking of exchange rate parities."

The second condition is no more than the fulfilment of the Single Market programme for financial services, because formal exchange controls have already been abolished by the major member states. The first and third conditions will be met most completely when there is a single currency throughout the EC.

The policy target of economic and monetary union (EMU) is now undoubted, if there ever was any doubt; the paper submitted to the April EC Finance Ministers meeting at Ashford Castle in Ireland states, under "the likely benefits of EMU ... i) the advantages of price stability" and, that EuroFed "should be explicitly committed to price stability."

The method of achieving EMU is set out in the Delors Committee Report in three stages. Looked at from the point of view of the saver, these are:

Stage One - A Process of Liberalisation

Stage One is "the initiation of the process" of EMU and starts on July 1, 1990. The key steps in Stage One are:

- "In the economic field ... a complete removal of physical, technical and fiscal barriers ... completion of the internal market would be accompanied by a strengthening of Community competition policy."
- "In the monetary field the focus would be on removing all obstacles to financial integration. Firstly, through the approval and enforcement of the necessary Community Directives, the objective of a single financial area in which all monetary and financial instruments circulate freely, and banking, securities and insurance services are offered uniformly throughout the area would be fully implemented. Secondly, it would be important to include all Community currencies in the EMS exchange rate mechanism. Thirdly, all impediments to the private use of the ECU would be removed."

A Single Financial Area Is Being Created...

Considerable strides have been taken in these areas in recent months, and even weeks. Thus, the completion of Stage One looks inevitable. Nonetheless, the timescale could be lengthy. The "full implementation" of all the liberalisation measures by means of national enabling legislation may take a couple of years from the dates stated in the Directives - often January 1, 1993. Regrettably, but realistically, it may be 1995 before Stage One can legitimately be declared complete, if the current rate of progress is maintained.

A convenient test of a member state's true commitment to monetary union might well be their record on (i) negotiating Directives which genuinely match the objectives of both the Werner and Delors Reports and (ii) implementing them in national law. These Directives should impose controls on investment flows only to the extent that public policy requires prudent regulation to ensure a stable financial system. This entails removing regulations whose underlying intention is to compel financial institutions to keep their assets - the people's savings - within specific member states.

...But Covert Exchange Controls Are Still In Force...

An example will illustrate the point. In most member states, life insurance is the largest part of long-term savings by individuals. To ensure the safety of these institutions, there are generally rules to ensure a congruency between the type of risks inherent in the liabilities (the insurance policies sold to the public) and the assets. If these insurance policies promise to pay a fixed sum of money in the future, then it is reasonable for the permitted assets to exclude unhedged foreign currency holdings. There is circularity to this argument: if the rules disallow "inflation-linked" assets, then a company cannot offer an "inflation-linked" policy. Which was cause and which was effect will only be of interest to historians.

The practical result is that even the EC's 1988 Second Directive on Non-Life Insurance enshrines these congruency principles in its "matching rules." This requires a currency matching of assets and liabilities, with minor exceptions and one significant one: "this [matching] requirement shall also be considered to be satisfied when up to 50% of the assets is expressed in ECU." **But how many member states have followed through the spirit of Stage One and implemented such relatively minor concessions in their own national law?**

Stage Two - An Irresistable Force

Stage Two is the transition period where "the results achieved through the implementation [my emphasis] of the Single Market programme would be reviewed..." The Ashford paper recommends "that the Community prepare for a relatively rapid passage from the beginning of Stage One to the definitive EMU, including a common currency." This would correspond to Stage Three of the Delors Committee proposals, but the Ashford paper makes a crucial distinction: a market-driven approach to the regulation of public finances.

Potential Instability

The rationale for this swift move through Stage Two is compelling: "as capital movements are fully liberalised and as this potential is realised by the completion of the internal market in financial services, there will be an increasing sensitivity of exchange rate pressures..., the progressive achievement of the goals of Stage One therefore both undermine the efficiency of national policy instruments and make the magnitude of their task more formidable..., strong analytical evidence and historical experience confirms that such a position is not durable".

Interestingly, this analysis of the instability of the transitional phase closely parallels the criticisms made by Sir Alan Walters - former economic adviser to UK prime minister Mrs Thatcher - in a recent speech at the City University in London. The "EMS plus free capital movements" is criticised by both friends and foes for good reason. **The quantity of capital which may flow will dwarf any conceivable European monetary fund and the speed of developments will test any monetary co-operation arrangements to destruction.**

The Impossibility Of A Two-Speed Europe

The dangers of Stage Two stem from "the EMS + free capital movement." The same combination will face any state that chooses the slow lane in a two-speed Europe. Effective free capital movement has two components: absence of exchange controls and liberalisation of financial services. Spain, Portugal, Greece and Ireland have derogations from the requirement to abolish exchange controls. Once financial services are liberalised, it may become difficult and highly illogical to enforce these controls. However, the notional constraints will remain to put a barrier in the way of money flows, so that a lower speed is feasible.

Once there is effective freedom of capital movement, it is impossible to envisage a state moving at a different speed for any length of time, without being subject to the risk of such destabilising flows that it will effectively have to move in synchronisation with the faster speed. This is true for the UK now; it will apply to the other four states once effective capital freedom occurs.

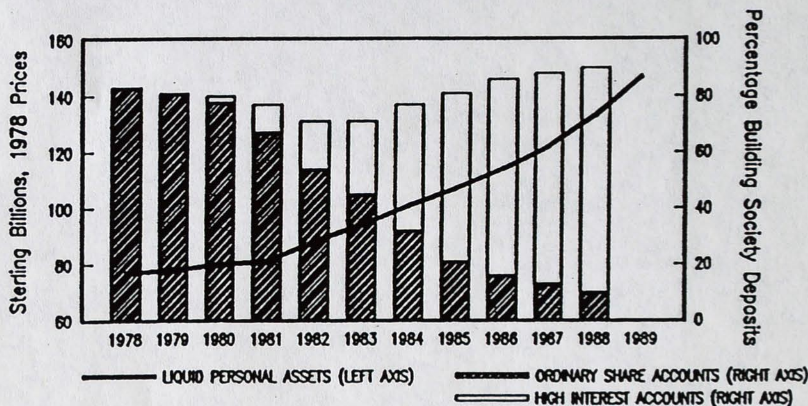
The Power Of The Saver

There should be little doubt that the single market in financial services will promote revolutionary changes over a period, which will only start once the Directives have been implemented in national law. This corresponds to the completion of Stage One. The Single Market is intended to promote competition and in this environment, where traditional boundaries will become blurred and even disappear, two selling points remain: efficient service and investment performance. We believe that the steady rise in consumer sophistication will be matched by a drive for higher performance. This may take the form of either higher returns/avoidance of risk with assets, or minimising the cost of borrowing.

Example One: UK Building Societies

British consumers have demonstrated substantial sophistication with their assets. Figure 1 provides an example of citizens' readiness to act to their own advantage.

Figure 1. Liquid Personal Assets Versus Building Society Holdings, 1978-89



Sources: Building Societies Association, Financial Statistics (CSO).

The line in Figure 1 shows that the personal sector's holding of liquid assets have roughly doubled since 1981, after allowing for the effects of inflation. Liberalisation of the banking system since 1980 exposed building societies to competition. Their customer base is regarded as financially unsophisticated, yet, once given the opportunity, savers switched almost entirely from "ordinary share accounts" paying interest at a discount of 30% or more to the market rate, into "high interest" (read market rate) accounts. Ordinary share accounts have now virtually disappeared - from 80% of funds to nothing in one decade.

The consequences of applying this degree of sophistication to their borrowings could be dramatic once the UK joins the Exchange Rate Mechanism and will increase exponentially as monetary union itself approaches.

Example Two: UK Mortgages

The "stock" of UK residential mortgages is £220 billion outstanding and their actual life, in contrast to the original 20-25 year term, is relatively short. Historically, each contract has had an average life of about seven years, but at the peak of the 1988 housing boom this had fallen to only five years. Thus the "flow" from the origination of new mortgages was over £50 billion that year. UK mortgages are floating rate - typically resulting in a rate of Libor + about 100 basis points. This gives a total borrowing cost of 16% at present. If the Government made a binding commitment to maintain the Sterling/Deutschemark rate unchanged - first, by joining the ERM and second, by signing a treaty of monetary union - there can be little doubt that a rising proportion of the electors would trust the Government's word. As a result, they would refinance their sterling mortgages with Deutschemark loans at 9%-10%.

If this were happening during a lengthy Stage Two when the UK was still attempting to pursue an independent monetary policy, then the potential capital flows would be dramatic. Most of the £250 billion stock of mortgages would be refinanced within a few years. This would create a flow so colossal that it seems unlikely that a buffer fund, or monetary cooperation, would survive intact. This extreme instability would have been caused by (a) trusting the UK citizens to make their own borrowing decisions, in the light of their elected government's pledges and (b) the failure to move rapidly to a uniform and stable monetary regime where such flows would be unnecessary. Such huge flows can hardly be described as "speculative attacks" - they would merely be individual electors rationally seeking to maximise their standard of living.

There is an implication for the conduct of UK monetary policy from this example. Once it is seen as "safe" (because it rests on the Government's pledge) to borrow in foreign currencies, UK monetary policy will cease to have any substantial effect. The citizens will simply by-pass the "high interest rate" policy - and let no one doubt that they would do so.

Example Three: Italian Public Debt

Another example illustrates again the potential scale of the instability of Stage Two. The Italian Government's debt maturity is relatively short, at about 2½ years. Given the size of the debt - close to 100% of GNP - this means that monthly redemptions of around $32 billion amount to almost 4% of GNP. Now that exchange controls have been abolished, if there were an unexpected crisis, this volume of liquidity placed back into the hands of savers each month could easily flow out of the currency as they try to protect their savings. The scale of such flows would rapidly overwhelm buffer funds and cooperation. **Again, the solution to such potential risks is to eliminate them by moving rapidly through the risky and unstable transitional phase to the stability of a single currency.**

At the Dublin Summit in April, the Heads of State made a commitment, which fell just short of an absolute deadline, to "the objective of ratification [of a treaty] by member states before the end of 1992." If that is achieved, then all the mechanisms will be ready for the start of Stage Three, and the risks of instability will rise steadily and rapidly as savers (and borrowers) begin to utilise the new freedoms which start, or should start, in 1993. Much of Stage Two amounts to enhanced cooperation between national central banks. This is already developing rapidly so that, in reality, **Stage Two will be concurrent, rather than consecutive, with Stage One.** Therefore, it is still technically possible that, by the end of 1993, the laggard member states could have implemented all the Single Market legislation and Stage Three can be implemented with the irrevocable locking of exchange rates.

Stage Three - The Search For High Quality Investments

Stage Three is the culmination of the whole process of monetary union - with a single currency issued by the European Central Bank, EuroFed. If this monetary union is to work properly and be durable, two issues must be completely resolved:

- **First, how much money is printed and who controls it.** This depends on what system is chosen for the central bank and its control, and investors can have no influence on whether this system works. I discuss this topic later.

- **Second, who is responsible for public debt.** If a country decides to spend recklessly, will the rest of the Community's taxpayers have to foot the bill? The rising reluctance of West German taxpayers to countenance a substantial tax increase to pay for East German needs suggests a very limited tolerance of such burdens.

The second question raises two interlinked issues and it is the solution of these that requires a framework of rules.

The Sovereignty Issue

Both the Delors Committee Report and the Ashford Paper highlight the need to preserve the "principle of subsidiarity" which entails leaving the maximum amount of power at the local level, rather than moving it to the Community level.

Sovereignty To Spend...

Thus, the debate on economic and monetary union has brought with it a debate on sovereignty. The proposal in the Delors Committee Report to set "binding budgetary rules" has aroused strong reactions, both for and against, because of its impact on sovereignty - implicitly, the sovereignty to spend. This follows from the elementary linkage: spending = taxation + money creation + borrowing. The proposals for monetary union would affect each of these three elements.

- The Single Market's goal is to give the citizens of Europe the four freedoms: free movement of people, goods, services and capital. If a state's tax regime is seen by its citizens as oppressive, then they will have the freedom to "vote with their feet." Thus, the Single Market will put an effective cap on oppressive taxation. Interestingly, that should not worry the current UK government, given the present composition of the tax structures - yet that government complains most forceably of lost sovereignty.

- The power to create money will now reside with EuroFed, the European Central Bank, subject to one priority task; the maintenance of price stability. It is agreed that there will be no monetary financing of public deficits.

- As borrowers, the public sector will no longer represent the perfect credit risk: the power to avoid formal default by printing more currency will have been removed from national central banks, and the latest plans for monetary union have made it crystal clear that there will be no Community bail-out of the profligate borrower. Thus, the ability to borrow will (i) depend on a state's creditworthiness, and (ii) be the residual component of the power to spend.

...Will Depend On Ability To Borrow

The result of this process is that the sovereign power of a member state to spend is ultimately limited by its creditworthiness - in other words, market discipline will be implemented by cutting off supplies of new credit ultimately. That is the moment when the elector - or the intermediary financial institution - is no longer prepared to risk further hard-earned savings.

Not Competing Currencies...

There has been much talk about competing currencies. Although "competing currencies" has a neat ring, the economic argument is really about competing "money" - debts that citizens are prepared to accept as being effectively interchangeable with currency.

A currency has two distinct roles: (i) as a method of paying for goods and services - the "medium of exchange", and (ii) as a convenient way of holding long-term savings - the "store of value". The "1992" programme emphasises the first role, because twelve separate media of exchange are obvious and substantial obstacles to a Single Market.

(Even in the UK, a single currency can be envisaged - Chancellor of the Exchequer John Major, in a recent Wall Street Journal interview, "conceded that he could even imagine the issuance of notes with the ECU value printed on one side and the pound value on the other." Interestingly, the United States is an extreme example of this type of monetary union. Warren Weber, of the Minneapolis Federal Reserve Bank, recently (WSJ 26 April 1990) pointed out that banknotes are issued by each of the twelve district Federal Reserve Banks and are specifically identifiable. However, there is "the assurance of total and irreversible convertibility", so the notes are treated as interchangeable.)

...But Competing Monies

Although the Single Market logically requires the simplicity of a single medium of exchange, or **currency**, there is still real scope for competing **monies**. States will compete to provide savers with the best store of value: the competition will be won by the state whose debt offers the highest chance of avoiding a loss in real value. (Whether this loss is caused by inflation or a formal default is of minor consequence to the saver: it is still a real loss, even though the formal default is much more noticeable). Thus the credit quality of a state's debts will determine the use of its money as a store of value, and therefore the interest rate that must be paid.

Therefore, citizens will have to look at the currency/money trade-off with new eyes. As a medium of exchange, EuroFed's single currency will be the obvious solution, because it can be used easily and cheaply throughout the world's largest economic bloc; moreover, it will probably be very acceptable in many other places as well. When savers look for a money that is a safe store of value, they will consider the risk of default. The risk of a surreptitious default-by-inflation will be common throughout the Community. If EuroFed fails in its priority task, the decision may be simple - look for a store of value outside the Community.

For savings purposes, the public is unlikely to be interested in public debts that do not pay interest, i.e. notes and coin - the traditional currency. Instead they may look at the "public money" that will compete with bank money [in the UK, National Savings versus building society deposits,] for example. Different countries have different boundaries for the final maturity of debts that may be called "money", but the improved efficiency of financial markets will blur these boundaries even more and extend the maturity range of debts considered marketable enough to be used as money. Therefore, for an increasing part of a state's debts, savers will assess the return they require on the basis of the credit risk involved in holding the public money issued by that state.

A Rolling Referendum On "Hard Money"

The result of this competition amongst the major countries could be surprising. Only the UK has a budget surplus and its indebtedness - measured by debt as a percentage of national output - is already below that of Germany, although above that of France. With Germany embarking on the unquantifiable venture of unification, the public money issued by the UK should look at least as attractive a store of value as any other. Even if EuroFed only succeeds in creating the monetary conditions that allow an inflation rate at the low end of the current European range, then there would be a major gain for the UK from this competition of monies. Eventually, the saving on the annual interest cost of the National Debt could be 3% or more - more than £5 billion annually.

This example shows the benefit of monetary union to the UK. It also shows that the UK's sovereignty to spend would be limited only by the need to keep faith with the savers of the UK, and the EC as a whole. Savers will have stored their value in UK public money, because they recognised the current sound state of public finances. If savers ever have any doubts about the soundness, they will be free to protect themselves against the risk of a formal default by withdrawing their savings from this particular store.

This rolling referendum on "hard money" policies would operate in all member states and would certainly enhance democratic accountability throughout the EC.

PRUDENTIAL RULES FOR A "HARD MONEY' UNION

"Who is responsible for public debt?" seems a simple question, but full and unambiguous answers go to the heart of the political system as well as the financial. The notes and coins of public debt have two sides: on the one side are printed the rules about issuing it; on the other, the rules governing the investors who purchase it. These rules must be designed to enhance market discipline to ensure that it operates slowly and progressively, rather than abruptly and catastrophically.

For the Issuer of Public Debt

The guiding principle is that the public finances of member states should be sufficiently sound that they cannot destabilise the EC's political and financial system.

This statement of principle immediately invites a definition of "sound." Regrettably, it is impossible to frame a numerical definition that is applicable to all member states, at all times. If debts had been incurred solely to finance long-lasting and readily marketable assets, such as houses, then the analytical approach to a company's balance sheet would be useful. At the other extreme, the debts might have financed the payment of pensions and therefore be nothing but a transfer between generations. The credit standing of these debts would then hinge only on the willingness of the next generation to pay the bill they have inherited.

The real world is a complex, and shifting, blend between these extremes. Even if we could define the type of debts, what is the "right" debt/income ratio? What is the maximum ratio? There is much alarm about Italy's debt, at 100% of GNP, but surprisingly little comment on Belgium's 135% debt/income ratio. Should more attention be given to true measures of credit quality, such as debt service ratios?

There are a number of key points for the regulation of the issuer:

Provision Of Full Information

Information on the full magnitude of a debtor's obligations must be available in order to assess its debt servicing capacity. This must include the contingent liabilities of entities beyond the central governments, such as public sector and state-guaranteed bodies. The Prospectus Directive (89/298/EEC) already requires publication of "information necessary to enable investors to make an informed assessment of the financial position of the issuer." However, Articles 2 and 5 exempt Member States and their subsidiary bodies from this requirement.

The position of commercial trading entities owned by the state - in particular, banks and insurance companies - must also be considered, as should that of private banks whose major business is gathering retail funds, purchasing government debt and holding it to maturity. The risk weighting system for bank assets, set out in the Solvency Ratio Directive, already requires a careful clarification of the exact status of these entities.

Accounting conventions and practices must be standardised sufficiently so that fully comparable data can be published promptly - perhaps by the European Commission. Prior to a common currency, the exact status of liabilities represented by notes and coins may present a problem, but that will be removed once they become the liability of the new central bank.

Surveillance

Administrative budgetary rules will be more difficult to develop and apply. At a minimum, they should require EC finance ministers to exert peer group pressure by vigorously, and publicly, warning on budgetary excesses.

Prudential Standards for Public Debt Maturity

"Prudential supervision" of public debt portfolios will be necessary. The "average life" of the debts will be the critical factor: as the maturity of a debt portfolio shortens, the risk of a sudden liquidity crisis rises correspondingly. In some case, confidence can be shaken by events that are completely outside the control of the debtor, who then will have difficulty in rolling over maturing debt, resulting in a rapidly deepening liquidity crisis; the New York City crisis of 1975 was a classic example. The risk of a liquidity crisis is particularly difficult for markets to price, because the burden, while in itself acceptable, may be poorly structured. As New York City discovered, once the liquidity crisis had struck, it proved impossible to sell significant quantities of debt even at **twice** the yield offered by other municipalities.

Perhaps five years might be an appropriate minimum average life. The occasional tremors of a liquidity crisis in Italy suggest that an average life of less than three years is definitely too short.

The maturity structure of public debt should be one of the specific items subject to surveillance by the EC finance ministers. If a member state allows its maturity structure to fall below the agreed minimum standards, this judgement should be publicised and lenders be obliged to recognise the decline in the quality of their assets.

EuroFed To Be Prohibited From Holding Public Debt

EuroFed should be prohibited from holding public sector debt. This would prevent its open-market operations from masking the emergence of a credit spread between different Member States and would remove completely any risk of direct monetary financing of government deficits. While an absolute prohibition may seem severe, it would remove temptation. The scale of private financial instruments within the EC as a whole should offer ample scope for the purchase or sale of securities to create, or eliminate, money.

The risk of monetary financing can be removed entirely (as advocated by paragraph 32 of the Delors Committee Report) by this prohibition.

No Market Privileges For Public Authorities

The Ashford paper states there is "virtual consensus" that there should be no market privileges for public authorities and that this rule "could feature in the treaty." The nature of these privileges was not spelled out but various types are readily identifiable:

- Taxes - whether withholding, income, capital or turnover
- Special uses - collateral for loans from the central bank, requirements that a proportion of assets of life insurance funds, for example, be held in public debt (see page 3 above), eligible asset for banks' mandatory liquid assets. This type of regulation is at the heart of the operation of the financial system and careful thought will be required to equalise access to the financial markets, yet maintain a balance of prudent regulation.
- Special support mechanisms - the central bank's role in "stabilising" the market in public debt. Stabilisation arrangements run the risk of negating market signals and so does the surreptitious provision of monetary finance (see the section on EuroFed above).

The abolition of such privileges will have far-reaching consequences for the structure of the financial system, but, if market discipline is intended to work, then it is essential that investors are not induced, or obliged, to invest in government debt **on any grounds other than creditworthiness.** Otherwise the market's early-warning signal of a widening credit differential will be blunted - if not offset entirely. Moreover, an investor who has been legally obliged to purchase a particular asset has a strong moral case for compensation from those who imposed the obligation, if there is a default. This would create the risk of the crucial no-bail out principle being progressively undermined.

These requirements appear to be merely technical measures for the efficient functioning of the financial system. However, they do go to the heart of the political system as well, quite separately from issues of sovereignty.

For the Purchasers of Public Debt

The liberalised market in financial services must be soundly regulated.

Apart from the new risk to the financial system of public sector defaults, the "old" risks stemming from commercial mistakes will not have vanished. In reality, the competition unleashed by the Single Market is likely to reinforce those risks. The freedom to gain market share carries the reciprocal freedom to lose it. As the citizens of Europe are offered new financial services and then progressively utilise those opportunities, there will be many surprising developments. These will need the right balance of regulatory vigilance to maintain the stability of the financial system yet not stifle innovation.

However, there are direct and explicit implications for the regulation of financial markets flowing from the implementation of Stage Three. Financial systems are normally structured on the assumption that central government debts, if not those of the public sector as a whole, are free of credit risk. This assumption, explicitly restated in the Cooke Committee rules for the capital adequacy standards of banks, has been incorporated into Community law through the Solvency Ratio Directive.

In the final analysis a government can always print money to repay the nominal amount of its debts. (The consequences for the real value of the debts are a separate issue). **However, the essence of monetary union is that Member States will lose this power to create money to repay their debts,** thus eliminating a fundamental tenet of current financial regulation.

The Ashford paper talks of "virtual consensus" that there would be no monetary financing of public deficits and no bailing-out of the fiscally imprudent. However, the financial system must then be strong enough to cope with a default by a public sector borrower, or no-one will believe that the "no bail-out" rule will be applied in practice. There are some basic requirements:

Large exposure rules

The prudential regulation of any financial institution generally involves a limit on the exposure to any single debtor (or group of associated debtors): at a certain threshold of exposure, separate reports to the supervisor are often required, and exposure above the level where a loss would be catastrophic to the whole institution is prohibited.

Currently, the EC does not apply exposure limits to central government debts, which are seen as free of credit risk. **The crucial, and essential, change is the recognition that, in a European monetary union, public debt will involve credit risk.** Hence, some limits should be applied, even though public debt will remain the best credit within the Community.

Exposure limits would be set out in the directives governing the particular type of institution. Two examples illustrate how this could be done by amending existing texts:

- Article 22, paragraph 1 of the UCITS Directive (85/611/EEC), which liberalises mutual funds, limits the exposure to any one entity to 5%. Paragraph 3 raises this to 35% for "securities issued by a Member State...", while Article 23 raises the limit for such securities to 100%, but "in accordance with the principle of risk-spreading," exposure to this one debtor must be in at least six different securities.

- The Recommendation on Large Exposures of Credit Institutions (87/62/EEC) proposes a limit of 40% of own funds in Article 4, paragraph 1. Paragraph 4 then states that "the competent authorities may fully or partially exempt... the public authorities of any of the Member States..."

The recognition that public debt carries some risk, even if only a small degree, argues that these exemptions from accepted prudential standards of risk diversification be removed.

Given the aggregate of the cash value of these limits on each institution, a Member State should have adequate borrowing power within the Community. As a broad concept, the financial institutions within a given Member State might have an aggregate limit equivalent to 60% of that state's gross national product (GNP) - providing that the corresponding individual institutional limits were not so large that default would undermine the institution. As the existing debt levels of the Community average out at 60% of GNP, institutions within a "prudent" Member State would not be compelled to change their behaviour. A further substantial percentage of GNP as an aggregate credit limit for that Member State might be spread amongst the financial institutions elsewhere in the Community. What this percentage should be is a matter for further study, but the explicit intention is that no financial institution should be endangered through its own over-exposure to the partial default of a state.

An institutional financing envelope equal to, say, 120% of GNP - nearly matching the heaviest debt burden within the Community currently - might seem lax. In reality, however, this would represent a major obstacle. Once a state had used up its domestic credit limits, its total reliance on nondomestic institutions would be a powerful brake on further borrowing. Even under the best conditions, a major state rarely has had a substantial proportion of its total debt held by foreigners. Spreading limits of even 60% of GNP around the rest of the EC would probably imply quite low limits at individual institutions, reducing the risk to the Community's financial system of a default.

Because total exposure limits would be based on GNP, the financing of a reasonable annual deficit should face few impediments. A state's relative debt burden would rise only if its new deficits exceeded the growth rate of its GNP. Thus, this approach would create a cumulatively tougher financing problem for "excess" deficits, but only if these were sustained for several years.

If a Member State wished to be ever more indebted, then it would have to raise the funds from non-Community institutions (or directly from individuals) - a difficult and expensive process. External creditors would be on notice, from the public warnings of the group of EC finance ministers, and would undoubtedly demand a significant premium.

Marking To Market Of Public Debt

If the price of a country's debt begins to deteriorate, then all financial institutions should be obliged to recognise this immediately, marking the asset down to the new market price and deducting the loss from their capital bases. Member States would have to be encouraged to issue debt in a marketable form, so that the market for such debt would be genuinely liquid and substantial and the market price would be seen as a reliable indicator. All nonmarket debt would be valued using the appropriate rate interpolated from the yield curve. For valuation purposes, nonmarket debt should be valued at a penal yield premium, perhaps one percentage point above the corresponding market yield. The same principle could be applied to nonmarket debt outside the Member State's own currency. The applicable yield curve would simply be that of the domestic government.

Provided that the market price accurately reflects the risk of default, then the financial system would adjust continuously, and the actual event of default would not create a shock; the loss provisions would have been made every day along the way.

The Delors Committee Report took the view that a rigorous application of market discipline could be "too sudden and disruptive." The application of large-exposure and mark-to-market rules should ensure that a debtor is progessively shut out of the financial markets but, historically, sudden crises have stemmed from illiquidity. An excessively short maturity debt portfolio heightens this risk, hence, the importance of the peer group pressure of EC finance ministers being applied to debt maturity, under the surveillance procedures.

A Sliding Scale Of Write-Offs For Debt of Substandard Average Life

There is also a case for introducing a sliding scale of required write-offs for all financial institutions, not just the banking system. The appropriate sliding scale is a matter of debate, but the clear intention would be to force the financial system to write down asset values sufficiently such that a serious default would already have been fully provided for in the capital of those institutions holding the debt. Therefore, the threat of a disastrous default - as an alternative to a forced bail-out - would be widely recognised as hollow.

Naturally, compulsory write-offs against capital would be a major disincentive to any financial institution considering the provision of further funds to a country sliding towards a liquidity crisis and a correspondingly heightened risk of default - even if only a partial default. As soon as such write-offs become significant, institutions would require a yield premium to compensate them for the loss. Thus, the sliding scale of write-offs should induce a progressive rise in interest costs as the debts' average life declined.

Amendation Of Capital Adequacy Rules For Banks

There is a specific problem which will have to be resolved. Otherwise, there will be a paradoxical and perverse result: the prudential rules on bank capital adequacy standards will turn out to be an engine of market **indiscipline.**

This result will stem from the Solvency Ratio Directive - which enacted the Cooke Committee rules of the BIS. On the assumption that central government debt is risk free, the Directive assigned a zero risk-weighting to this debt. Therefore, if a state's creditworthiness declines to the point where its Treasury bills yield in excess of Libor then the return on the zero capital requirement for banks will be infinite. This perverse mechanism will generate huge supplies of short-term funds at yields only slightly above Libor. In other words, the cost may be a blow to national pride but will not represent a fiscal problem. Thus the banking system's search for a high return on capital will lead the debtor straight into a liquidity trap and expose the banking system to dramatic losses. Recent history underlines, all too vividly, the banking system's capacity to over-exploit these opportunities.

As EC public sector debt will no longer be risk free, this weighting system must be changed or it will short-circuit any process of market discipline and could lead to catastrophe for the debtor, even if the banks are protected by rules against "large exposures."

This plan is based upon a matrix approach. Along one axis is a set of exposure limits for Community financial institutions. These limits would be low enough to ensure that the default of a public borrower would not undermine any institution. On the other axis of the matrix is the price effect. Taking a level playing field approach to all financial institutions, the marking to market of all public debt would progressively freeze out of the credit markets those countries about whose creditworthiness the market became concerned for any reason. Hence, at the moment of threatened default, the financial system would already have written off the problem, so the threat could then be viewed entirely in the political context.

This plan is designed primarily to protect the saver from the consequences of public indebtedness, but all these mechanisms would merely serve to put all parties - politicians, regulators, electors, and investors - on notice that a problem is growing. They would create a series of ever-tougher credit crunches. Ultimately, they would ensure that the final sanction of withdrawing further credit supplies is not catastrophic for the financial system of the Community. They would not withdraw the right of any Member State to slide down the bumpy slope to fiscal ruin.

THE CENTRAL BANK - EUROFED

The creation of a successful EC "hard money" union hinges on the control of public debt. The degree of control exercised by member states will determine their success in competing to have their debt used as 'money' which the citizens of Europe can use on a store of value. However, the common factor throughout Europe will be the stability of prices. This will determine whether non-Community 'money' will be even better. Investors cannot influence whether the system works but its success is just as important as the prudence of public finance.

There are three aspects to the structure of EuroFed:

Its Tasks

There is complete agreement that "...it should be explicitly committed to price stability. Subject to this priority, the policy should support the general economic policy objectives..."

An Appropriate Constitution

The Ashford paper suggests that the "stance of monetary policy" be set by the EuroFed Council, which would consist of:

- the 12 Governors of the national central banks;
- a Board of professional staff with long, secure terms - numbering less than 12 and including the chairman;

  In addition the President of the European Commission and the President of the European Council would "be present" at the EuroFed Council meetings. Democratic accountability is stressed and would be achieved by:

- periodic reports to the European Council;
- periodic reports to, and hearings with, the European Parliament.

There is stress on the need for independence - both in the conduct of policy and of the Governors from their national authorities. However, there is silence on the key question of who appoints the Board: should it be the European Parliament, the European Council or some other system?

The problem of achieving independence may be easier in practice than in constitutional theory.

First, the Community-wide abolition of exchange controls has brought into operation the market mechanism of automatic stabilisers - of capital flows. There will be no impediments to well-informed investors - either individually or collectively through financial institutions - moving their capital out of the European Community if it becomes clear that EuroFed is failing in its priority task: price stability.

This capital outflow will automatically tighten internal monetary conditions and will have a critically important role because EuroFed will not be able to "sterilise" such flows very easily. In an existing national system, an unwelcome inflow of liquidity can be sterilised as far as the private sector is concerned, by absorbing it via additional sales of government debt. This presents no problem when the government has no need to be concerned about its credit standing. However, governments may be loath to issue unnecessary debt when this is being carefully scrutinised by the markets. In particular, a government already close to a visible deterioration of creditworthiness may be disinclined to accept an additional burden. In the case of an outflow of capital, the situation is reversed. If EuroFed were prevented by its "rules" from creating additional money, then monetary conditions would be automatically tightened. In effect, the structured absence of a simple method of sterilisation will have re-introduced one of the best features of the Gold Standard - an automatic system to draw the economy back to stability.

Secondly, independent behaviour by the EuroFed Council - both collectively and individually - will be greatly encouraged by borrowing another feature of the US Federal Reserve Board - publication of policy decisions, the rationale for them and the voting record of members. Correspondingly, reports to the European Council and Parliament, together with all hearings, should be public. If there are any shortcomings in the independent pursuit of price stability, such publicity will immediately put investors on alert and enable them to take protective action.

The Necessary Powers

The central banks of Europe have evolved over the centuries in reponse to widely varying circumstances. The persistent analogies with the development of the US Federal Reserve System do not consider whether that particular balance of historical forces - principally those operating in the first third of this century - are relevant to the Europe which will be emerging a century later.

The supervision of banks and of the payments system are issues for separate discussion. Historically, these two roles have conflicted with the conduct of sound monetary policy. Hence, separate technical agencies may be better placed to perform these regulatory functions. If the level playing field concept spreads to all financial intermediaries, the complexities of regulation will grow.

This raises the risk that the principle of subsidiarity will be compromised. Already the "Ashford paper" seems to have slipped into this trap: advocating that "the national central banks would remain responsible for the smooth functioning of the national systems of payments" yet also stating that "it is clear that it should be based on the ability of EuroFed to have ... ultimate responsibility for the payment system". Therefore it is appropriate to limit the role of EuroFed solely to that which is strictly necessary to achieve its priority task: price stability. This limitation will enable the EuroFed Council to focus exclusively on its one task and remove the risk of dilution and confusion by extraneous, technical matters.

Monetary Policy

In the conduct of monetary policy, EuroFed will have "the freedom from obligations to take actions which would undermine the basic objective of stability". If Monetary Union is to be presented to the electors of Europe as a mechanism carefully designed to ensure price stability, then this formulation is too weak. It appears to leave the EuroFed Council with a voluntary opportunity, rather than "obligation", to undermine stability. There should be a formal prohibition on such actions. This would correspond to the tough proposition - on which there is 'virtual consensus' - that there be "no monetary financing of public deficits or market privileges for the public authorities".

The practical way of achieving this intention is simple: EuroFed should be prohibited from holding public sector debt. The fungibility of money means that newly created money could still flow into public debt but only through the market's willingness to purchase the debt at a price which reflected credit perceptions. The prohibition would serve to prevent EuroFed's open-market operations ["regulation of money conditions should generally be made by ...mainly open market operations"] from masking the emergence of a credit spread between different member states. It would remove completely any risk of direct monetary financing of government deficits. A prohibition may seem severe but it removes all temptation.

The scale of private financial instruments within the EC as a whole should offer ample scope for the purchase or sale of securities to create, or eliminate, money. There will be a greater credit risk but it would not be the first time that taxpayers have lost money, whether through foreign exchange intervention or other direct policy actions such as subsidies.

Foreign Exchange

Foreign exchange policy seems a particularly grey area, perhaps reflecting the diversity of formal legal ownership of the national foreign exchange reserves - is it the Treasury or Central Bank? Nonetheless, the "Ashford paper" comes down firmly, and correctly, in favour of "foreign exchange interventions ... should not be in contradiction with the final objective of monetary policy ie price stability" As a result, it concludes that "the decision on intervention in foreign exchange markets and the day-to-day management of exchange reserves should rest with EuroFed..".

Undoubtedly, this topic has the potential to spark furious bureaucratic debate but perhaps it will turn out to be a minor issue - more contentious in constitutional theory than in practice. A common currency in the Community will, by itself eliminate a large proportion of current foreign exchange intervention. In the United States, direct intervention in the foreign exchange markets is minimal. The external value of the currency is influenced, more powerfully and permanently, by the conduct of monetary policy. Even if this conflict of ownership is not resolved unambiguously, the discipine of the financial markets will act as a stabiliser - any confusion and conflict of purpose in foreign exchange policy will be seen as a sign of weakness in pursuing the priority goal: price stability. Investors will draw their own conclusions and the capital outflow will bring into action the "Gold Standard" type of automatic stabilisers.

Memorandum

An implication of this analysis is that EuroFed will be a minimalist organisation. There will be a modest staff to support the Board, but execution of policy will be delegated to existing organisations in line with the principle of subsidiarity. There is a clear analogy with the policy-making Federal Reserve Board in Washington and the various Federal Reserve Banks, such as New York, which execute policy. The Board is less than one tenth of the size of the combined Banks (measured by staff costs), and this includes supervisory and technical functions which would be entirely outside the role of EuroFed.

The absence of an executive function focuses the market's attention on the true significance of the board and its policy-making discussions and decisions. In a world of modern communications, the physical location of such a minimal organisation is not a matter for the committment of national prestige. It certainly does not imply that the financial markets will migrate to wherever EuroFed's boardroom is located.

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OTHER TITLES IN THE "1992 AND BEYOND" SERIES

Fortress Europe?, October 1988. Examines the potential problems facing Japan in its trade relationships with Europe.

Banking -- Will Liberalisation Itself Lead To A Common Currency?, February 1989. Genuine liberalisation of financial services will unleash market forces, which will, by themselves, create effective monetary union.

The Long March To European Monetary Union -- Two Practical Steps, May 1989. In part, a response to the Delors Committee Report, pointing out that monetary union was possible without binding rules. Also detailed the barriers to free capital flows caused by regulations such as the West German restrictions on the investment of insurance assets.

The Madrid Summit -- European Monetary Union IS Coming, July 1989. An analysis of EC measures on financial liberalisation and the linkage with monetary union. Discusses achievements to date and what remains to be done.

Market Discipline CAN Work In The EC Monetary Union (with Dirk Damrau and Michelle Miller), November 1989. The lessons from other monetary unions (Canada, Australia, West Germany); the New York City crisis of 1975. The market can be a more effective sanction on fiscal profligacy than binding rules.

Creating EC Monetary Union with Binding Market Rules, February 22, 1990. A plan to ensure that market discipline is certain, yet operates slowly and progressively. This plan proposes specific measures to strengthen the structure of the financial system sufficiently that a Member State's default is not disastrous.

Italian Public Debt at the Dawn of Monetary Union -- A Foreigner's View, February 1990. An analysis of Italy's debt problems, highlighting the short maturity and proposing a major foreign borrowing programme in other EMS currencies to stabilise the stock of debt.

Higher Bank Capital = Securitisation, March 1990. The combination of higher bank capital adequacy requirements and the creation of a "level playing field" for all financial services in the EC will produce spectacular change in the next five years. An inevitable result will be the emergence of a major market in asset-backed securities.

When Will Sterling Join the ERM -- Domestic Versus European Timetables (with Malcolm Roberts), March 29, 1990. An analysis of the UK domestic timetable for lowering inflation and interest rates ahead of an election, in the context of ERM membership. The European timetable has accelerated beyond ERM issues and the EC plans a common currency soon, posing a dilemma for the UK.

Eastern Europe and the European Community, June 15, 1990 (with Ann O'Kelly). Outlines the rapidly evolving relationships between the principal European blocs: the EC and Eastern Europe on the one hand, and the EC and the European Free Trade Association (EFTA) on the other.

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Today, the EC's economic success contrasts with Communism's economic failure. EC membership has been beneficial to the countries involved: it has brought considerable economic convergence to the six original members (Belgium, France, Italy, Luxembourg, the Netherlands and West Germany), and an increase in living standards across the Community. The EC now rivals Japan and the US as an economic power, and its importance will increase with the completion of the Single Market.

The Benefits of the Structural Funds

The EC aims to promote economic convergence between its members. GNP per head for the EC's poorest member, Portugal, is only around a quarter of that of the richest member, Denmark. To reduce these disparities in conjunction with the Single Market plan, the EC's structural funds are being doubled in size from ECU7.2 billion in 1987 to ECU14.5 billion ($17.7 billion at present exchange rates) in 1992 — equivalent to one quarter of the Community budget. A major programme is underway for resource transfers to the four least-advanced countries — Portugal, Greece, Spain and Ireland. The impact will be significant: in 1992, the transfers will represent between 2.5% to 3.5% of these countries' GNP. These transfers should increase GNP per head substantially.

If there were a mechanism to enable Eastern Europe to participate in the EC, then the next generation could look forward to a standard of living three or four times greater than their parents' current standards. The EC's original insight that economic links will promote political stability remains relevant today in the enlarged Europe.

EFTA

A Halfway House?

It has been suggested that the European Free Trade Association (EFTA) could represent a halfway house for Eastern European countries intending to join the EC. EFTA — comprising Austria, Finland, Iceland, Norway, Sweden and Switzerland — operates a free trade area for industrial goods only. It does not have a central executive authority, so each EFTA country has a bilateral free trade agreement with the EC. However, comparing per-capita GNP in Figure 1, it is difficult to envisage the countries of Central and Eastern Europe joining up with EFTA, where the average GNP per head is *above* that of the EC.

European Economic Space

In 1984, EFTA and the EC agreed to form an 18-nation European Economic Space (EES). Little progress has been made on the EES, in contrast to the 1985 plan for a 12-nation Single Market by 1992, whose success has caused some consternation in EFTA countries. Negotiations are due to begin shortly on extending the "four freedoms" — freedom of movement of goods, services, capital and people — throughout the EES. However, although the April Summit stated that *"the Community attaches great interest in, and will work actively for, early agreement with our EFTA partners on the establishment of a European Economic Area,"* negotiations are unlikely to be speedy or straightforward. The EC is preoccupied with its internal organisation and its reaction to the emerging East European countries. It fears that EFTA's lack of a central executive authority will necessitate detailed negotiations with six different EFTA countries — EFTA has requested a large number of exemptions from EC rules. EFTA, on the other hand, wishes to remain a simple trading bloc and is unwilling to form a central decision-making authority. It is also loath to take over a large amount of EC secondary legislation without a say in the shaping of future EC policies. However, the EC is unlikely to grant a share in the decision-making process to nonmembers.

As the success of the Single Market becomes more apparent, EFTA countries increasingly fear being shut out: the EC and EFTA are important trading partners, accounting for about 70% of all exports and 65% of all imports of the 18 nations combined. Increasing numbers of EFTA companies are establishing footholds in the EC by either setting up subsidiaries here or purchasing EC companies.

In July 1989, Austria applied for EC membership. If the EES negotiations fail, other EFTA members may follow Austria's move.

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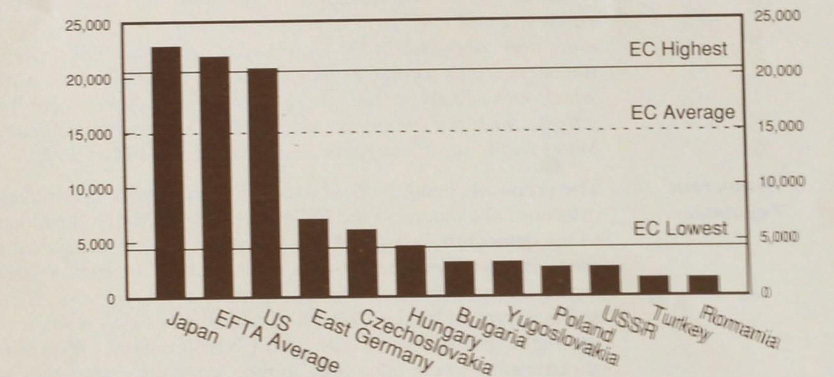
Eastern Europe and the European Community

Europe has entered a stage of rapid evolution. Over the past year, the monolith of "Eastern Europe" has broken with startling rapidity into individual, independent, newly-democratic states. The European Community (EC), on the other hand, has quickened its pace towards eventual union: January 1, 1993 now heralds not only the completion of the Single Market, but perhaps also the next stages of economic, monetary — and political — union.

The enlarged Europe contains countries of widely differing economic strength, as shown in Figure 1. If a mechanism can be found that allows Eastern Europe to share in the growing prosperity of the West, then the long-term impact could be dramatic. This report outlines the rapidly evolving relationships between the principal European blocs: the EC and Eastern Europe on the one hand, and the EC and the European Free Trade Association (EFTA) on the other.

Figure 1. GNP Per Head, 1989 (Dollars in Thousands)



GNP Gross national product.
Sources: OECD, Salomon Brothers Inc estimates.

The Evolving EC

The changes in the Eastern bloc have had a considerable impact on the EC. Although the 1987 Single European Act set a long-term goal of "European Union," the immediate preoccupation was the completion of the Single Market in 1992, followed by a measured progress towards economic and monetary union (EMU). The events in Eastern Europe over the past year have changed this timetable. Paradoxically, moves towards monetary and political union have been accelerated. The need to respond rapidly and flexibly to the changing European situation has made it clear that institutional changes are necessary in the EC structure.

The decisive stimulus came from the reunification of Germany and the wish to bind the two Germanies together under a "European roof." (Interestingly, the wish to bind postwar West Germany to a wider, peaceful Europe led to the formation of the EC's forerunner, the European Coal and Steel Community.)

In April 1990, West Germany's Chancellor Kohl and France's President Mitterrand added political union to the EC agenda: *"Given the profound changes in Europe, the establishment of an internal market and the realisation of economic and monetary union, we believe it is necessary to accelerate the political construction of the 12 [EC countries]. We believe the time has come to 'transform the nature of relations between the member states into a European Union and to give this the necessary means of action,' as stated in the Single European Act."* The special EC Summit on Eastern Europe, held in Dublin on April 28, concurred: *"a point has now been reached where the continued dynamic development of the Community has become an imperative. . . . The European Council therefore agrees that further decisive steps should be taken towards European Unity."*

Economic and Monetary Union

The first stage of EMU starts on July 1, 1990. An Intergovernmental Conference (IGC) opens in December 1990 to draft changes to the Treaty of Rome in order to facilitate the next stages of EMU. The April Summit has now accelerated the IGC's deliberations by setting *"the objective of ratification by Member States [of Treaty changes] before the end of 1992."* Given general agreement that Stage Two of EMU be brief, it could even be possible that 1993 might see a common currency and a European central bank.

Political Union

The April Summit *"reaffirmed its commitment to political union"* and stated that *"the Community will act as a political entity on the international scene."* EC foreign ministers are to carry out a detailed examination of *"the need for possible treaty changes with the aim of strengthening the democratic legitimacy of the union, enabling the Community and its Institutions to respond efficiently and effectively to the demands of the new situation, and assuring unity and coherence in the Community's international action."* EC foreign ministers are to prepare proposals for the Dublin Summit at the end of June, which looks likely to call *"a second intergovernmental conference to work in parallel with the conference on EMU with a view to ratification by Member States in the same timeframe,"* i.e., before the end of 1992.

Democratic Legitimacy

The proposals being worked out by foreign ministers are likely to involve institutional changes in the EC's structure. Although the Community is devoted to the democratic ideal and a commitment to democracy is a precondition for entry, its own structure shows a considerable "democratic deficit." An increasing proportion of the laws governing EC citizens originates in Brussels and is approved by the Council of Ministers in closed session, often in late-night "horse-trading" sessions. Commissioners, appointed by national governments, swear allegiance to the Community when they take office, but have little democratic accountability — the 17 Commissioners may be sacked as a group by the European Parliament (EP), but not individually. The directly elected EP has little power: it can amend legislative proposals, but may not originate them, and in some countries, institutional links between the national parliament and the EP are inadequate.

Options being floated for institutional changes include a greater role for the EP, perhaps including the power to elect the President of the Commission, an increased use of majority voting in the European Council, and the formation of an "EC Senate" from members of national parliaments.

The next few years are likely to see considerable changes in the EC from the completion of the Single Market and from the steps taken towards union. However, in view of the historic changes in the rest of Europe, the EC may need to guard against letting its internal preoccupations create a "Fortress EC" within Europe.

The Breaking Up of the Eastern Bloc

In 1989, the "Year of Revolution," the Communist monopoly of power disappeared in Central and Eastern Europe. The new democratic governments are turning to the West for assistance with vast economic and structural problems.

Western Aid

Substantial aid from the G-24 group of Western industrialised nations is being coordinated through the European Commission — $12 billion has been pledged so far, mainly to Poland and Hungary. The EC itself is giving ECU500 million ($610 million) in aid to Central and Eastern Europe this year, ECU850 million ($1.04 billion) in 1991 and ECU1 billion ($1.2 billion) in 1992. The European Bank for Reconstruction and Development (EBRD) has been set up, with a capital of ECU10 billion ($12.2 billion) provided by 40 different countries, of which 51% is from the EC. At least 60% of annual lending will be to the private sector.

However, aid from the G-24 governments — whether bilaterally or via the EC — should only be a small part of the capital that could flow into Eastern Europe under the right conditions. Eastern European countries will need to make radical economic changes and develop more sophisticated financial systems. Sensibly, these systems are being created so that the Eastern European countries can easily be subject to EC "mutual recognition" standards. This change should enable EC private sector capital flows — both debt and equity — to move autonomously to fund projects that offer good economic returns.

Trade Agreements

The EC has just signed "first generation" bilateral trade and economic cooperation agreements with Poland, Hungary, the Soviet Union, Czechoslovakia, East Germany and Bulgaria. (The EC gained formal recognition by the Eastern bloc only in 1988.) These agreements gradually remove quotas on imports to the EC and promote economic cooperation. At present, Eastern European countries account for only around 3% of total EC trade — a slightly lower percentage than when the Community was founded.

Association Agreements

The EC is now planning "second generation" association agreements. The April Summit stated that *"discussions will start forthwith . . . on Association Agreements with each of the countries of Central and Eastern Europe, which include an institutional framework for political dialogue. The Community will work to complete Association negotiations with these countries as soon as possible on the understanding that the basic conditions with regard to democratic principles and transition towards a market economy are fulfilled."*

The agreements would possibly involve a customs union with the EC and improved access to EC finance. However, in view of the uncertainty of economic development in Central and Eastern European countries, the EC is unwilling for the agreements to include an explicit commitment to eventual membership. (A similar commitment in Turkey's 1963 association agreement is felt to have tied the Community's hands.) Poland, Hungary and Czechoslovakia are eager for association negotiations to start and all have expressed a wish to join the EC — Czechoslovakia hopes to fulfil the conditions for membership before the end of the decade.

Who Can Join the EC?

According to Article 237 of the Treaty of Rome, *"any European State may apply to become a member of the Community."* Democratic government is a precondition — Greece, Portugal and Spain were considered for membership only after the restoration of democracy. The conditions of admission must be approved unanimously by the European Council and by an absolute majority of the EP. Agreement must then be ratified by all the contracting states.

Negotiation of membership is a lengthy process, because new members are required to accept not only all the provisions of the EC Treaties, but also the entire *acquis communautaire* — that is, all the secondary legislation. Negotiations deal mainly with the length and nature of the transitional period during which the applicant state must modify its existing laws, and the provisions that are to be included in such transitional arrangements. (For example, Portugal and Spain applied in 1977, signed the Treaty of Accession in 1985 and became members on January 1, 1986, with a seven- to ten-year transition period for aligning import duties and the Common Agricultural Policy.) However, Central and Eastern European countries will in any case need to make radical structural changes; if legislation and manufacturing standards compatible with those of the EC are adopted, there will be less need for a long transition period.

Two applications for EC membership are already pending: Turkey applied in 1987 and Austria in 1989. The EC has stated that it does not intend to consider enlarging the EC until after the completion of the Single Market.

Economic Compatibility

The EC is also not eager to admit new members with an economic level well below that of the EC. Turkey's economic backwardness is one of the reasons cited for deferring negotiations on its entry application. Turkey's GNP ($1,500 per head) is around one third of that of the EC's poorest member and is also below that of all Eastern European countries, except Romania. (However, Eastern European GNP data are less than reliable.) On the evidence of Figure 1, East Germany, Czechoslovakia and Hungary are nearest to being possible candidates for EC membership — the success of Poland's economic experiment will not be clear for some time.

East Germany

East Germany is a special case: it will be incorporated in the EC through its reunification with West Germany. Economic, monetary and social union between the two Germanies has been fixed for July 1, 1990. Formal reunification will probably take place under Clause 23 of the West German Constitution, whereby the reconstituted East German *Länder*, or regions, vote to adhere to the Federal Republic. According to the April Summit, *"integration [in the EC] will become effective as soon as [German] [re]unification is legally established. . . It will be carried out without revision of the [EC] Treaties."* Reunification costs are being borne by West Germany without recourse to the EC, and there will be a transitional period for the introduction of EC regulations.

The Lure of the EC

The fundamental attraction of the EC for Eastern Europe is its economic success. The EC was set up at a time when Central and Eastern Europe were under Communist rule and a new society was being constructed according to Marxist-Leninist rules. The 1951 European Coal and Steel Community (ECSC), and its 1957 successor, the EC, were founded to knit Western Europe together as a counterbalance to a perceived threat from the East. Despite its name, the ECSC had far-reaching ideals: *"to create, by establishing an economic community, the basis for a broader and deeper community among peoples long divided by bloody conflicts."* Its goals were *"economic expansion, growth of employment and a rising standard of living in the Member States."*