CHANCELLOR OF THE EXCHEQUER

~~Paul~~

We spoke about the attached paper from the Board of Academic Advisers in the FRG.

JR.

1. ~~CDP~~ – may like to see

2. CF – pe EMU.

BRCG
29/10

From:

Board of Academic Advisers
to the
Federal Ministry of Economic Affairs

Bonn, June 5, 1989

Mr Ohlig-Smee

I assume you have seen this. Should we draw it to the Chancellor's attention? Please return.

16/10

To:

Dr. Helmut Haussmann,
Federal Minister of Economic Affairs

5300 Bonn 1

Dear Mr. Minister,

The Committee set up by the European Council for studying and proposing concrete steps leading towards economic and monetary union in Europe (Delors-Committee) has completed and submitted its report. This report presents many requirements and proposals to be considered before the ultimate objective can be obtained. To this extent, the Delors report and the positive acceptance it has received in many European countries should be welcomed. On the other hand, the Delors Committee has also adopted positions to which serious objections must be raised. A rash political adoption of the basic tenets of the Delors Committee's proposals means setting out on a problematic road. The Board of Academic Advisers wishes to comment briefly in this letter on a number of critical points in that report. Our remarks mainly refer to the stages preceding the economic and monetary union as well as to its eventual shape. Moreover, the Board of Academic Advisers wishes to draw attention to its Study entitled "A Monetary Order for the Single European Market" dated January 20/21, 1989.

1. For the period prior to the completion of the union, the Delors Committee wishes to propose a strategy whereby the EC Member States accept from the outset the irreversibility of their action and must all agree to keep the goal of parallel progress in economic and monetary integration in mind. The rejection of the socalled "crowning" theory - the idea that the monetary union would crown economic integration which has shown sufficient results - is not unjustified. However, the risks inherent in the proposed strategy must be contained. A premature decision to go beyond the point of no return would be too dangerous if it included the construction of new institutions

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which we can only hope will provide satisfactory monetary stability and if at the same time it irrevocably dismantled the current proven ones. The Deutsche Bundesbank and its monetary constitution are achievements too valuable to allow their erosion and excessive reshaping before the prospects for the success of the economic and monetary union have been positively established. We deem particularly dangerous the risk that transitional arrangements ultimately become permanent ones, although they would represent a deterioration of conditions in comparison to the status quo, at least from the point of view of those countries that are especially committed to economic and monetary stability.

2. The basic guidance the Delors Committee offers for the road towards a monetary union is reflected by the idea that monetary policy in Europe should gradually become the responsibility of the European Community. Many of the procedures suggested for the two phases prior to the eventual monetary union in Europe serve this idea. With due respect to the difficulty of the task of providing the necessary guidance (for increasingly convergent economic policies) to the EC Member States in this period, the Board of Academic Advisers rejects this idea. The Community's monetary policy is being guided quite well by the Deutsche Bundesbank, a fact which has been acknowledged in the Delors Report. The hope for the future is that such - no less competent - guidance will come from a European Central Bank, which is to be eventually created. However, the approach suggested for the meantime, to increasingly leave such guidance de facto to coordinating EEC bodies, is contradictory. The Delors report proposes that during the second stage the ultimate responsibility be held by the national central banks, however under the guidance of coordinating bodies actual responsibility would tend to fall to them leaving the national banks' responsibilities a mere formality.

The new definition of the mandate and the institutional enlargement of the already existing European Council of Central Bank Governors by the three sub-committees as proposed by the Delors Committee is also problematic. This proposal would in fact give the Council a weight that is incompatible with the autonomy of national central banks that at present cannot be given up.

The largely undisputed insight that the conditions in the Community for a monetary union committed to stability have not yet been satisfied must be firmly borne in mind. At present, the Deutschmark is - for good reasons -

the anchor of the European Monetary System (EMS); monetary policy coordination is strongly effected by market forces. The asymmetrical adjustment mechanisms inherent in the EMS are largely responsible for its success. The Delors report proposes giving up this asymmetry at an appropriate moment in favour of a European Central Bank with power to act. This step should not be taken prematurely, nor even gradually. Currently, there is no substitute for the anchor function of the strongest of the large EMS currencies. Installing a community-wide monetary policy in place of the Deutschmark's anchor function would be tantamount to opting for a drag anchor. As long as many Community Member States have not exposed themselves to the test of running stability-oriented policies in an environment of completely free capital movements, there is no guarantee that the ex-ante coordination by European bodies will lead to a policy course that is sufficiently commited to stability. The fact that the proposed coordinating bodies are not to be formally given the final say in monetary policy before the end of the second stage, is not a justification for introducing this proposal either. The stages prior to a monetary union require the strengthening of coordination through market forces, rather than a rash substitution of them.

3. The Delors Committee proposes a federally shaped European central bank system whose decision-making body is to be independent and unambiguously committed to monetary stability. The independence of the decision-making body, however, requires the independence of each of its members. Since monetary policy is not an area for national compromises, the European central bank should not be organized on a federal or multilevel basis which is likely to provoke such compromises. Therefore, we should not allow the national representatives of the European decision-making body to be answerable in some form or another, possibly as central bank presidents, to their respective governments. (The Deutsche Bundesbank, with its Landeszentralbanken as regional administrative centres, is ultimately an example of a one-level central bank system as well.)

Since such independence has not been provided, at least not for the proposed second stage, and since an independent European Central Bank that does not have the last word in matters of monetary policy would not make sense either, the whole concept of a two-stage transition period leading to a monetary union is problematic. The proposal that the European central bank system grow on a step-by-step basis into its functions, while the final responsibility for monetary policy action is to remain with the national bodies, may turn out to be a disastrous contradiction.

The aspects already mentioned in paragraphs 1 and 2 must be considered as well. There should, with respect to the new institutions, be a smooth and continuous period leading to monetary union. This period would initially bear the characteristics of economic policy coordination effected by market forces within the EMS. During this time, there should not be any mention of "formulating and enforcing a common monetary policy". The intra-Community monetary cooperation that already exists could increase considerably and become more binding in so far as the real convergence of economic policy towards stability is successful, and as the Delors Committee's recommendation to give greater autonomy to all central banks in Europe is acted upon. If possible, the central banks' legal responsibilities should be harmonized as well. A European Central Bank would be set up only at the end of this period. If its organizational structure is to be a federal one, complete independence of the participating national central banks would have to be ensured in advance.

4. The Delors Committee demands a "common exchange rate policy" vis-à-vis third countries. The basic tenets of this policy should be defined by community institutions in collaboration with the European central bank system. The latter should execute the agreed-upon policy. However, if there is a permanent exchange rate policy that is ultimately superimposed on monetary policy by EEC authorities, whose actions are guided by employment, growth and, possibly, foreign policy concerns, the outcome could be an impairment of the European Central Bank's independent policy towards monetary stability.

5. The Delors Committee's vision of a European economic and monetary union is based on the idea that, beyond monetary policy, effective ex-ante coordination between all areas of economic policy and all Member States is necessary. In spite of the welcomed acknowledgement of market forces, the Delors Committee's basic distrust of the coordinating force of the market and the help markets can provide in coordinating the national policies of the participating countries is ubiquitous throughout the whole Report. The value of proposals resulting from such distrust is highly questionable from the point of view of the market order and its constitution as well as from the area of impact analysis.

This applies to fiscal policy in particular. The Board of Academic Advisers deems it neither necessary nor desirable, first to institute to the extent proposed a binding ex-ante fiscal policy coordination based on majority voting among EC- Member States, and second to enforce coordination between fiscal and monetary policies of the member countries. A required ex-ante coordination of the Member States' fiscal policies, e.g. in the form of rules governing the upper limits for the budget deficits of individual Member States, is cause for concern, because it would mean intervening in powers that belong to the very core of national sovereignty.

It is certainly true that a considerable measure of economic and, especially, fiscal policy convergence is indispensable to an economic and monetary union, and also required for the transition to permanently fixed exchange rates or a single European currency. However, it is the results of the convergence that are important, not so much the measures taken to achieve them. Policy convergence may occur spontaneously, being brought about, as the case may be, by market forces. This outcome is to be expected when economic conditions, including monetary policy, are correct from the point of view of "Ordnungspolitik", i.e. the market order as a whole. As far as structural and regional policies are concerned, they must be pursued competitively through strict adherence by the individual nations to the rules of free competition. Above all, selective subsidies on a national basis should be strictly forbidden; here responsibility rests with the Community. The Board of Academic Advisers has already offered a detailed opposition to the hypothesis that an economic and monetary union per se would create additional demand for intra-Community transfers in its opinion "A Monetary Order for the Single European Market".

In its Report, the Delors Committee pays more attention than justified to the idea of permanent demand management, or "macroeconomic management". This reflects an emphasis on obsolete notions, rather than on the experience of the last decade. Here again the stipulated ex-ante coordination of Member States' general economic policies and the report's requirement of a common definition of monetary policy calls for opposition.

Monetary policy must be unambiguously committed to monetary stability and to objective money supply criteria. This principle is upheld in some parts of the Delors Report, but in other parts it receeds into the background behind macroeconomic management. At present, those EMS Member States which don't hold anchor currencies must subject their economic policies to the constraints emanating from a monetary policy formulated by those countries with the strongest currencies, i.e. currently the policy of the Deutsche Bundesbank (as long as an exchange rate variation is not desired). Ex-ante coordination of economic and monetary policies by European authorities will mean that monetary policies must - time and again - be aligned with what is politically feasible for the system as a whole. Experience has taught us that this will not lead to stable money.

In this area basic general economic policy differences become visible. The Delors Committee does avoid extreme positions here. However, where it should give incentives and build in constraints for member states to do what is right in their own interests, it trusts too much in the proper functioning of new institutions, i.e., the new agencies which hopefully will identify and arrange policies for the good of all.

6. In summary, the Board of Academic Advisers deems the following actions necessary:

(1) The final responsibility and autonomy of the Deutsche Bundesbank for a monetary policy oriented towards stability must not be questioned, either directly or indirectly, before the end of the period resulting in a monetary union.

(2) The period leading to a monetary union should consist not of two, but of just one stage. A European Central Bank will be created only at the end of this period. For this simple reason, there is no need for an early commencement of negotiations to modify the Treaty as required by the Delors report.

(3) Monetary policy does not lend itself to the compromises which will occur in a federally shaped European central bank system. If this form is nonetheless chosen, the system - like that of the Deutsche Bundesbank - must ultimately be a de facto, single-level one; this means opinion-formation should be at a single level and there should be no dependent relationship from third parties at any level.

(4) Informal coordination of economic policies through market forces shall have priority over formal ex-ante coordination by European bodies. In monetary policy, too, new forms of a de facto binding coordination emerging in the period preceding monetary union can be considered only with strong

reservations. Every step in this direction must depend on how far actual convergence of economic policies towards stability has come and to what extent national central banks have achieved the level of independence necessary for monetary stability.

(5) Stability-oriented monetary policy must not be impaired by a "common exchange-rate policy ".

(6) The formal institutionalized coordination of general economic and fiscal policies proposed by the Delors Committee should be limited to the very modest level that is really indispensable to an economic and monetary union and constitutionally justifiable at the same time. The EC Member States require more, not less, fiscal policy autonomy than the federal states of the Federal Republic of Germany have at present.

(7) An economic and monetary union does not create an additional unavoidable demand for an European structural and regional policy; on the other hand, there is an increasing need to preclude state-caused distortions of competition. European structural and regional policies which compensate for errors in other policy areas, including wage-policy, are not only to be avoided, but are harmful with respect to incentives for preventing such policy errors as well.

Accept, Mr. Minister, the assurance of our highest consideration.

sgd. Prof. Dr. Christian Watrin
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