2 The All Saints' Day Manifesto for European Monetary Union

We, the undersigned, concerned at the lack of progress towards the goal of European monetary union to which the governments of the member countries of the European Community have repeatedly committed themselves, and at the harmful consequences of the inflation which we are experiencing, present this manifesto to the public in the belief that our proposal offers the best way of achieving a monetary system which will be not only European-wide in scope but stable as well.

This manifesto, then, is a statement of purpose based on what we consider to be sound economic analysis and at the same time in accord with the political aspirations of our time. Our emphasis on the use of market forces stems from our conviction that it is difficult to bring about a monetary union by official edict or by the establishment of grandiose insitutions, no matter how well intentioned. On the contrary, we are convinced that it is for the people themselves to decide whether they want monetary union or not and that the only satisfactory way they can be given the opportunity to do so is by the introduction of a parallel stable money, as we explain below, which they may accept or reject as they wish. We believe they will accept it but we believe equally that they must accept it freely.

LESSONS FROM EXPERIENCE

Proposals for monetary integration appeared in the Werner report which set full economic and monetary union as a target to be achieved in three stages over a period of 10 years. The recommendations of the report were adopted as a goal of the European Community in March, 1971. Monetary union was identified with (1) total and irreversible convertibility of currencies; (2) elimination of margins of fluctuation in exchange rates; (3) irrevocable fixing of parities; (4) elimination of restrictions on capital movements; and (5) co-ordination of aggregate demand policies.

As in most endeavours which try to alter radically the course of events, the Werner report suffered from an excess of idealism. It overestimated the

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willingness of governments to depart fr... national decision-making because it underestimated the costs associated with a f... setting of ultimate targets and the policy strategy necessary to meet such targets. We are aware that governments have different priorities with respect to the goals of high employment and inflation and that they have tried over the years to trade the achievement of one goal against the other. To the extent that wide differences of opinion remain about the scope and even the existence of such a trade-off, we must conclude that a common policy of the member countries is not feasible. Fixed rates of exchange necessarily imply *grosso modo* a common rate of inflation for participating countries. Therefore, the premature implementation of a rigid exchange rate regime, in the absence of monetary policy co-ordination, is bound to lead to balance of payments crises; in turn, these crises will either destroy the union or bring about a general misallocation of resources, of which unemployment will be the most visible and politically sensitive aspect.

The Werner approach concentrated political attention on exchange rate unification. It provided, therefore, intellectual justification for the 'snake' arrangement, instituted by the Community in March 1972. The snake scheme is essentially tantamount to the formation of a cartel where each member retains the right of opting out of the system. The opting-out provisions were necessary because of the failure to implement a system of quotas based on credible money supply targets. It is hardly surprising that it did not stand up fully against some of the strains it had to face.

A major weakness of the earlier approach based on co-ordinated decision-making is its non-automatic nature and its reliance on political discretion. Monetary unification, if it is to succeed at all, must be brought about by a gradual process. From a political point of view, it is necessary to proceed gradually so that nationalist feelings are not provoked by sudden losses of what are perceived to be national powers. The earlier approach, although gradual, was discretionary: the co-ordination of economic, monetary and exchange rate policies was based on an infinite series of painful compromises and concessions. It maximised political friction for minimal economic results. From an economic angle the case for gradualism and automaticity is the case for market processes.

The lesson we draw from the foregoing is that an approach to monetary unification which is based on co-ordination of policies will fail because it involves the locking of exchange rates without monetary reform. The approach we advocate is radically different in that it achieves monetary unification through monetary reform based on the free interplay of market forces.

THE CASE FOR A SINGLE STABLE MONEY

Money has a comparative advantage in transmitting information and in reducing uncertainty. The introduction of money in a barter economy frees resources which were previously absorbed by economic agents in finding

'appropriate' exchange rates between goods. The case for a monetary union is similar to the case for a monetary rather than a barter system. But the single money, which will eventually replace separate national currencies, has to possess purchasing power stability.

That a single stable money is better than multiple currencies (even if they are stable) as a medium of exchange is obvious from the fact that socially unproductive transactions between currencies are entirely eliminated. In its role as a store of value, a single currency with stable purchasing power would serve the community better than the existing arrangement of many currencies. Most importantly, it would eliminate exchange risks which are generated primarily by uncertainty as to how much money each central bank will supply in relation to the demand for this money. We believe it inappropriate to suggest that these risks may be eliminated by forward operations. The forward markets, beyond three months, are simply not that well developed and, even if they were, the resources devoted to them could be entirely freed by a single currency.

The aspect of multiple currencies which is probably most costly to society is its impairment of the efficiency of money as a unit of account or standard of value, since there is no common standard of value in a multiple-currency-flexible-exchange-rate system.

The objection that a single money is not necessary and that a fixed exchange rate between multiple currencies would perform equally well is only partly correct. It is true that currency transaction costs are reduced, but that is all. The more important disadvantages of multiple monies, the creation of uncertainty and the impairment of the efficiency of money as a unit of account, still remain. Experience with fixed exchange rates has been one of long stretches of little exchange rate flexibility interspersed by large jumps in parities. Uncertainty about parity changes has never been eliminated. Fixed exchange rates are inferior in this respect to flexible rates, and, in turn, flexible rates are inferior to a single stable-valued monetary system.

COPING WITH IMBALANCE

The main argument against monetary union is that it would be likely to result in an unwanted combination of unemployment and inflation in some or all members of the union. This argument derives from the negative relationship which is thought to prevail between unemployment and inflation. The studies undertaken in the 1950s and 1960s, which showed that this kind of relationship seemed to hold, have now been corrected. More recent studies indicate that, in the long run, employment is independent of the rate of inflation. We urge governments to accept the conclusion which follows from this, namely, that monetary policy, whilst influencing the rate of inflation, cannot reduce what has come to be called the 'natural' rate of employment, i.e. the rate of unemployment which is determined by labour market conditions, taxation policy, and a variety of structural and institutional factors. Accordingly, any

attempt to drive the rate of unemployment below the 'natural' rate by means of expansionary monetary policies will be self-defeating and will engender a process of accelerating inflation. Since the rate of unemployment is not, in the long run, related to changes in the price level, a monetary union cannot be regarded as a cause of unemployment.

We recognise that the tendency for labour and capital to move to the central highly-developed areas from the peripheral areas may be accentuated by a monetary union. The reason is that wages in the peripheral low-productivity areas may be increased to the level of those in the high-productivity areas while productivity differentials remain unchanged. Consequently, unit labour costs in the peripheral areas may become so high that firms which previously were viable may no longer be able to pay their way and the prospect of a satisfactory return on new investment may disappear. Should that happen, capital would tend to move to the high-productivity areas and thereby attract labour to move from the peripheral to the central areas.

In Europe regional diversity is highly, and in our view rightly, valued. We consider, therefore, that monetary union should not be permitted to encourage the movement of labour and capital to the central developed areas at the expense of the peripheral and less developed regions. For this reason we look upon a vigorous regional policy as an integral part of monetary unification in the European Community. We regard it as essential that such a policy should concentrate on eliminating the causes of regional imbalance by raising productivity levels in the poorer areas and that income transfers to alleviate the consequences of low productivity should be used as an interim measure only.

The transition to a European monetary union would not, of course, be without difficulties. The higher a country's rate of inflation is, the greater these difficulties would be. For a country with a rate of inflation as high as that in the United Kingdom the transition might involve a recession lasting for several years. It is not surprising that many people consider this too high a price to pay for monetary union, especially as the teaching of two generations of economists has been that domestic demand management policies can be relied upon to achieve any desired level of employment.

In the long run the need to reduce high inflation rates is virtually inescapable so that ultimately the consequences of bringing inflation under control have to be borne whether a country joins a monetary union or not. The introduction of a new stable money that is not subject to inflationary expectations will, however, minimise the transitional costs.

A COMMON EUROPEAN MONEY: THE EUROPA

Monetary reform to fight inflation will become more urgent the longer the current inflationary situation lasts. The launching of a new common European money, the Europa, offers a unique opportunity of carrying out this monetary reform while at the same time setting the pace for monetary integration. The most radical approach would be to replace the existing national currencies

by a stable European money in one drastic move. We rule this out because it violates the principle of gradualism and would not give the people any choice in the matter. Moreover, it would produce a severe stabilisation crisis in most countries.

The approach we advocate offers both gradualism and automaticity, and is based on monetary reform and on the free interplay of market forces. We propose the launching of a parallel European money of constant purchasing power, issued in accordance with a European monetary treaty, that would circulate along with the existing national currencies.

The presence of a stable European money will compel governments to replace the implicit tax now existing on holders of money with explicit taxation. With money keeping a constant purchasing power, the issuer earns seigniorage on each Europa which is equal to the real rate of interest on perfectly liquid and riskless assets minus the costs of issuing, replacement and policing against forgery; if the money loses its value, an additional burden is imposed on the holders of money which is equivalent to a tax. In the absence of money illusion, this inflation tax is equal to the difference between the nominal and the real rate of interest, i.e., the expected rate of inflation. To eliminate the inflation tax on the holders of Europas is to offer them a purchasing-power guarantee.

To propose a Europa of stable purchasing power is to invite the question why a problem which proves so difficult in the case of the national monies should be so easy to solve in the case of the parallel money. The answer is twofold. One, it makes a great difference from what position one starts. It is much easier to prevent inflation than to eliminate it. This is the reason why many times in history the creation of a new money has been preferred to a stabilisation of the old money; this is also the reason for linking European monetary unification with European monetary reform. Two, during the transition period (i.e., the period during which national monies and Europas co-exist), it is easier to achieve a constant purchasing power of Europas than of national monies. This is so because, while the purchasing power of a national money depends on how the public reacts to changes in its supply, the purchasing power of a parallel money can be stabilised with absolute precision if the issuer administers the exchange rate of the Europa vis-a-vis the national monies directly through currency conversions.

The adoption of the Europa requires one major political decision on the part of each national government: to permit their residents to use and to hold Europas in competition with national money. The fate of the Europa, however, will be determined in the market place by the economic operators.

INFLATION-PROOF EUROPA

The mechanism for maintaining a stable Europa, while it circulates alongside national monies, can be rather simple. Its essence is to keep the price level of a representative commodity basket constant in terms of Europas. The commodity basket can be defined as the weighted sum of the national commodity

baskets used to calculate the national consum[illegible]ice indices. The weights ought to reflect the relative share of each country in community GNP, intra-community trade, etc. The Europa itself is expressed in terms of a (weighted) basket of national monies.

Europas will be exchanged against the basket of national monies at a variable exchange rate that would be implied by the maintenance of a constant purchasing power of the Europa. As a practical guideline, the exchange rates between national monies and the Europa would be adjusted according to a crawling peg formula. The timing of the crawl would depend on that of the publication of the relevant price indices. This would amount to adjusting the exchange rate between the Europa and each of the national monies by a weighted average of inflation rates of consumer prices expressed in national monies.

When the Europa has ultimately replaced national monies, its supply should be controlled according to a monetary rule that would continue to guarantee its purchasing power stability.

THE EUROPA SOVEREIGNTY

Initially, we envisage that the central banks would issue the Europa against national monies only. In that way it would not add to the total community stock of money. Only at a later stage would it be issued through rediscounting of bills and other loans to the banking system, through open market operations or through financing of community expenditures. To the extent that the issue of a stable Europa will raise the demand for real money balances, such additions to the money stock can be absorbed without a simultaneous fall in the demand for national monies.

Will monetary policy be more conducive to long-run stability in the monetary union than in the existing arrangement? The answer to this important question depends on the type of institution or institutions which will eventually replace national monetary authorities. Whatever the details of the arrangement, it would be wise to keep in mind one guiding principle: we must give the monetary authorities the same independence from political control and the same responsibility to the rule of law we have accorded the judicial system. It follows that the new institution or institutions should be removed from the jurisdiction of treasuries, and monetary authorities should be appointed or elected for long periods of time, if not for life. The purpose of these two features is to assure a longer time horizon than can be found in other branches of government.

SUMMARY

We recapitulate the principal propositions emerging from the document.

1. It is d[illegible]ult to envisage a monetary union created by official edicts and legalistic structures. It must evolve in the market place.
2. The benefits of a monetary union are qualitatively similar to the benefits accruing to a society as it moves from a barter to a monetary arrangement.
3. The case for a monetary union is not a case for fixed exchange rates in a world of many monies. It is rather a case for the replacement of all national monies with one common unit of account, medium of exchange and store of value.
4. The single money (Europa) which will replace national monies must have stability of purchasing power.
5. Our vision of monetary union differs from other visions in that we do not emphasise labour and capital mobility but rely on structural policies to correct possible regional imbalances.
6. There are no unemployment costs in monetary unification in the long run. The abdication of the national monopoly to print money has consequences only for the national rate of inflation, not for the long-run rate of unemployment.
7. The cost of monetary unification is transitional and results from the temporary loss of employment as the country adjusts its inflation rate to the union inflation rate.
8. The adoption of the Europa presupposes the political will to harmonise inflation rates among countries. It also presupposes that national governments will be willing to replace the inflation tax with explicit taxation. We thus call for a full-fledged monetary reform.
9. In the period when the Europa and national monies will coexist, the quantity of Europas will be solely determined by the desires of those who want to hold it. Conversions between Europas and national monies will occur at variable ratios.
10. To preserve the benefits of the monetary reform, i.e., the benefits which derive from a stable-valued money, monetary authorities should be given the same independence from political power and the same responsibilities to the rule of law we have accorded the judicial system.

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