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The Werner Report and the Future Monetary Integration of the Community

- A Discussion Paper -

The Community, the global economy, and perceptions of economic policy making have all changed since the Werner Report was written. This note analyses the conclusions of that report for the final objective for the first stage and briefly the transitional phase to outline these changes and in that light to assess what has already been achieved and what remains to be done.

I. The final objective

I. 1. Economic and Monetary Union.

The Werner Report defined economic and monetary union in a way that clearly links it to the achievement of a completed single market. It is said that it "will make it possible to realise an area within which goods services, people and capital will circulate freely and without competitive distortions, without thereby giving rise to structural and regional disequilibrium."

Equilibrium within this area, it was said, would be achieved, as within the borders of a nation, by the mobility of factors of production and financial transfers by public and private sectors. The most fundamental question, then as now, is how far the Community is from meeting this goal. On the one hand, despite the actual and proposed increases in the size of the Community budget, its economic significance generally remains weak compared with that of national budgets. On the other hand, the budget is (i) larger than when the Werner report was written; and (ii) for some of the most concerned Member States it has (and increasingly will have) considerable economic significance. By 1992 Portugal, Greece and Ireland will be receiving inflows of grants and loans between 3.1/2 to 6.1/2% of their GDP (and therefore 15 to 30% of their gross investment) through Community instruments. The transfers even to larger countries like Spain and Italy will be greater than 1% of GNP. Furthermore it is not only public financial transfers through the Community budget that are important for achieving an equilibrium within the whole area, but also both other public flows and most importantly the mobility of factors of production. Conditions for mobility, especially of capital, have changed quite dramatically.

I. 2. Monetary Union

Monetary Union was defined in the Werner Report as "the total and irreversible convertibility of currencies, the elimination of margins of fluctuation in exchange rates, the irrevocable fixing of parity rates and the complete liberation of movements of capital". It was thought that this could be accompanied by the establishment of a sole Community currency; but as in the described circumstances each currency would be a perfect substitute for the others, this was not a necessary requirement.

The Werner Report was written against the background of the Bretton Woods System, in which exchange rates were largely fixed. The decision to change a parity was a little used but powerful policy instrument. The experiences in the international monetary system of the floating-rate regime during the 1970's, and the more recent move towards a managed rate system, as well as those of the EMS within Europe have drastically altered views about the exchange rate as a policy instrument, and its ability to either absorb differences between policy stances or to shape the real economy.

A fundamental question is the degree of effective policy autonomy that is given up (and/or perceived to be given up) by not having a distinct national currency policy. The framework for answering this question lies in two other considerations:-

- (i) the efficiency of nominal exchange rate changes as an instrument to affect real exchange rates;
- (ii) the relative impact of real exchange rate changes and of changes in the levels of demand;

The questions are whether there are necessary real adjustments which require changes in real exchange rates and whether these can be most efficiently achieved by jumps in nominal rates. There is increasing evidence that demand policies are more effective than changes in the real exchange rate for the correction of current account imbalances, because the structures and inter-penetration of European economies means that price elasticities are low relative to income elasticities. Furthermore, the ability of nominal exchange rate changes to bring about lasting real exchange rate changes may be more limited within the Community than in the global economy, especially if rate changes are kept relatively small as in recent realignments and as recommended by the Nyborg agreement. These considerations, while suggesting a changed role for the exchange rate, also suggest an increase in the importance of the co-ordination of policy instruments which directly affect demand, and those which can bring about changes in real exchange rates by affecting domestic prices and wages.

The above discussion has concentrated on the links between the exchange rate and the real side of the economy. The EMS has had a notable degree of success in achieving its fundamental objective of a zone of monetary stability, and hence in both bringing down the average rate of inflation and differences between the inflation rates of participants. Changes in nominal exchange rates permit and at least in some circumstances promote differences in inflation rates. The ability however for a nation to choose its own inflation rate has an effect on many other economic variables.

In the absence of the possibility to change exchange rates, i. e. under a system of irrevocably fixed rates or a single currency, there remains the question of the extent to which there can be any independence of monetary policies. It is for example interesting to note that even today separate Federal Reserve districts can, and do, have discount rates which differ.

I. 3. Specific Instruments

These more general considerations aside, the Werner Report also said that the instruments of economic policy would have to be harmonised in the following sectors:-

- . Quantitative medium-term objectives for the Community level of growth, employment prices and external equilibrium. The Werner Report puts considerable emphasis on medium term planning, which is less relevant to-day. It however remains true that any economic area must have some way of determining the basic goals of economic policy, and the indicator exercise which has recently been started in the Monetary Committee is a move towards the joint determination of basic objectives of economic policy.
- . Principal decisions of monetary policy must be made in common. Again this is as true now as then, although there have been changes in the importance of particular policy variables, and generally a shift towards more market based instruments.
- . Budget policy. The Werner Report was strongly influenced by the conception that budgetary policy is a powerful instrument both for influencing the structural features of an economy and its short-term economic situation. Views on both, but especially on the ability of budget changes to fine-tune the economy, have shifted considerably. The experiences of the 1970's have also changed perceptions about trade-offs between employment and prices.
- . Fiscal harmonisation. The Werner Report recognised the need for a sufficient degree of harmonisation of VAT, excise duties and taxes likely to have an influence on the movement of capital. The Commission's proposals for VAT and excise duties are on the table; and proposals for the fiscal treatment of income from capital are required for the end of 1988.
- . Regional and structural policies cannot in an economic and monetary union be exclusively a matter for national budgets. This was the position of the Werner Report, and it is a point of view that is fully recognised in the decisions made at the Brussels Council in February. A fundamental question, as briefly discussed above, is the extent to which any financial flows - especially budgetary flows - have to be larger because of the absence of the use of the exchange rate as a policy instrument.

I. 4. Institutional Questions

The Werner Report did not give detailed proposals for the institutions that would be necessary for the final stage; but it said that two organs would be necessary:

(i) A Centre of Decision for Economic Policy

It is interesting to note that the Werner group said that changes in the parity of the sole currency (or group of currencies with fixed bilateral rates) would be the competence of this centre. The other main tasks of the Centre would have been the setting of overall policy, and influencing national budgets "especially as regards the level and direction of the balances and the methods for financing the deficits or utilising the surpluses".

Even if the power of budgetary policy for determining the short-term performance of an economy is viewed differently today; the question of the possibilities for the individual pursuit of differentiated budgetary policy within a monetary union is still a central one. Its poiancy is increased by the much larger disparities of both deficits and public debt which now exist.

Table. Government Debt and Deficits as a % of GDP

	<u>Debt</u>		<u>Net Lending or Borrowing</u>	
	1973	1987	1970	1987
B	63.2	124.8	-3.3	-7.2
DK	5.0	58.4	5.2	2.1
D	18.6	43.7	1.2	-1.7
F	22.7	36.7	0.9	-2.5
IRL	60.1	133.5	-8.2	-8.5
I	52.1	93.4	-6.1	-10.5
L	20.4	15.0	3.3	5.6
NL	43.3	79.0	0.8	-5.1
UK	63.3	54.2	-2.7	-1.4
Average	38.7	71.0	-1.0	-3.2

(ii) A Community System for the Central Banks

The Werner Report suggested that this could be based on the Federal Reserve System. At the time the relationships between Central Banks were conducted within the framework given by the Bretton Woods system. This has been replaced, to some extent for the Community central banks, by the EMS; and for some of them especially its exchange rate mechanism, which has given rise to a much higher level of co-operation than was evident during the period immediately after which the Bretton Woods system collapsed. This level of co-operation and joint determination of monetary policy of course still falls short of the arrangements of the Fed, both institutionally and in practice.

II. THE FIRST STAGE

The Werner Report put considerable emphasis on the first stage, which was aimed mainly at the reinforcement of the co-ordination of economic policies, which was therefore seen as a necessary pre-condition for moving to later stages and towards the final objective. Although it was said that the first stage should not be seen as an end in itself, it was relatively self-contained. An indication was given that it should last three years, but no detailed time-table for subsequent stages and developments was given. The only overall indication being that the final objective could be achieved within the decade. Given this goal, the ambitions of the first stage, especially on the institutional side, were modest.

II. 1. Procedures

The procedures specified were those which were subsequently given a legislative form by the 1974 Convergence Decision. These procedures never worked well and have now become basically redundant. Alternative and more powerful ad hoc procedures for co-ordination have however grown up especially around the EMS.

Although many of the specific methods and procedures recommended by the Report did not work out as foreseen, it is generally notable that in many areas the essential conditions of the first phase have been accomplished. This becomes evident on consideration of the recommendations for policies.

II. 2. Policies

- Budget policy. As discussed above, the Werner Report was drafted on the basis of the efficacy of the fine-tuning. As well as calling for the harmonization of time-tables, and of the presentation and adoption of budgets; it required the development of homologous instruments like "fiscal regulators" and "cyclical budgets".

- . Fiscal Policy. The provisions in the Werner Report for the first stage are remarkably similar to those given for the final stage, in that it refers to the approximation of VAT and the need to harmonise the fiscal regime applied to interest payments on fixed interest securities and dividends. As discussed above, both these items are already part of the current programme.
- . Policy for financial markets. The Werner Report calls for prompt action on two fronts: the abolition of obstacles to capital movements and a co-ordination of policies as regards financial markets. Agreement has already been reached on the former at the June ECO/FIN; and the programme which will allow the liberalisation of financial services and the creation of a single financial area is well advanced.
- . Domestic Monetary and Credit Policy. The report mainly addressed the question of the conformity of the instruments of monetary and credit policy, because at the time there was a much heavier reliance on non-market based instruments. This has fundamentally changed with the general adoption of market based instruments. Furthermore the co-ordination of policy has progressed through the EMS.
- . External monetary policy. The Werner Report reflects the dollar dominance of the international monetary system of the time. It was then seen that currencies would be pegged to the dollar and that exchange rate fluctuations would be defined against this point. The total change in international monetary relations both poses a different problem to the Community, and new opportunities and responsibilities. To the extent that a multi-polar system is developing, there is an added necessity that the Community defines its monetary identity.

III. Transition towards the Final Objective

The Werner Report, as said above, concentrated on fully specifying the first stage and on defining the ultimate goal. It did not add much about the transition between the two. Essentially it said that all the things advocated for stage one should be applied more intensely.

It is however worth noting that it said that during the second stage Member States should progressively abandon the use of parity changes as an autonomous policy instrument. The EMS has already brought the ERM members a considerable distance down that road. Realignments have to be by common accord, whereas the Werner report said that "only at the moment of transition to the final stage will autonomous parity changes be totally excluded."

The Report also called for the setting-up of a European Fund for monetary co-operation. It was thought that if progress was rapid, the Fund could be set up during the first stage, but otherwise it would be set up in the second phase. The purposes and duties of the Fund were not well specified. The only indication given was that it would absorb the mechanisms for monetary support at short term and for financial aid at medium term.

It was therefore to be predominantly, at least in the beginning, a fund rather than a banking institution. The way in which it would progressively expand its functions was not explored. When it was set up in 1977, it was not under the control of the central banks, as had been called for in the Werner Report. Article 2 of its statutes gives considerable powers to the Council over the Board of Governors of the Fund. This has contributed to the result that it has remained an empty institution.

Finally it was also said in the Report that as "progress is achieved towards economic and monetary union the fund will gradually become an organ of management of the reserves at the Community level". At the start of the EMS a system of swaps involving the transfer to the EMCF of 20 percent of the gold and dollar reserves of each central bank was set up. The mechanics of this system were such that it avoided any joint management of reserves, but it does result in some pooling and in the creation of the ECU. The ECU has had a limited use within the System. By contrast the private use of the ECU has grown considerably, raising the question of the role of a common, but not necessarily unique, currency in the development of the monetary construction of Europe.