Outline of problems connected with a European economic union

1. Preliminary remarks

Rightly, the mandate for the group of experts is not confined to discussing only the problems posed by the monetary integration process and approaches to monetary union, but it also embeds this question in the broader context of an economic union. In view of the future role of monetary policy in the Community it must be asked, in particular, whether an economic union presupposes further progress towards integration in the monetary policy field. Moreover, it is necessary to investigate which minimum requirements of integration in the real economy and of coordination in general economic policy would have to be fulfilled in order to enable the further evolution of the European Monetary System into a single economic and monetary area to be pursued step by step with some prospect of success - i.e. ultimately with an increase in prosperity for all Community countries.

The construction of a single European economic area must undoubtedly be accompanied by further integration of economic policies as well. How many responsibilities will have to be transferred to centralised economic policy bodies depends on the desired level of integration and political thinking about the constitutional structure of the economic union to be formed. Contrary to the statements frequently made in the political area, a common internal market does not essentially require either a common currency or a system of fixed exchange rates. If major differences in the socio-economic environment persist and if the EC countries' economic policies are not completely coordinated, exchange rate adjustments in fact appear to be necessary in order to absorb as smoothly as possible tensions within the Community resulting from price disparities and discrepancies in economic developments, as well as external shocks, such as upsurges in oil and commodity prices.

On the other hand, a single European market would be incompatible with sustained, "overshooting" exchange rate changes that are not caused by the above-mentioned disparities. In particular, the functioning of a common internal market would be called into question if exchange rate changes were being aimed at in order to strengthen the competitiveness of a country without justification. A minimum of economic "predictability" of exchange rate movements, such as is being aimed at through the EMS, will probably facilitate further progress on the way to an economic union. Exchange rate conditions that promote integration presuppose, however, that economic policies in the Community - and not only monetary policy - are already coordinated to a certain extent, if not harmonised.

Progressive economic union requires above all a regulatory and structural policy consensus and as great a measure of agreement as possible on economic policy goals and priorities. In connection with a monetary union, i.e. full and irreversible currency convertibility and irrevocable parity fixing, more far-reaching harmonisation demands will have to be made of an economic union. As a consequence of finally fixed exchange rates - and in addition to general regulatory and structural policy and macro-economic fundamentals - a general and binding coordination of procedural policy is essential, such as jointly defined budgetary, income and monetary policies which permit the successful achievement of common economic goals, as well as a comprehensive European regional and structural policy which supports the catching-up process of less developed zones within the Community. In conjunction with the monetary union, the economic union comes close to full economic integration; at this stage, the Community already presupposes a large measure of political harmonisation, in which the central bodies can take, in the most important economic policy areas, decisions which are binding on the member countries.

The decisive stage in the progressive implementation of an economic and monetary union is the transition to irreversible exchange rates. In formulating concrete steps towards the realisation of an economic and monetary union, this "qualitative leap" requires particular attention. In this paper, the elements of an economic union and the corresponding need for economic policy coordination are therefore investigated, firstly, in a context of fixed but adjustable exchange rates ("soft" economic union) and, secondly, in a context of finally fixed parities ("hard" economic union).

On the basis of past experience it is assumed here that integration policy will be satisfied with the "soft" form of economic union as long as it is not possible politically and economically to accept fully and irrevocably the consequences of a far-reaching surrender of autonomy, such as is associated with the final fixing of exchange rates. Owing to its much stricter requirements, however, monetary union cannot precede economic union. It is not suitable as a "pace-setter" for implementing the single market. On the other hand, owing to the efficiency and productivity gains to be expected, economic union is an attractive goal - though by no means one that will be easy to achieve - even in the absence of a monetary union. This goal will require a certain surrender of sovereignty, but leaves room for more far-reaching solutions in the future.

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2. Concept and operating conditions of the economic union

Basically, the establishment of an economic union involves the formation of a common internal market and the coordination of economic policies which is necessary to safeguard the micro-economic advantages of a sizeable economic area.

As far as the single market is concerned, it is characterised internally by the free movement of goods, services, capital and labour, and externally by common (liberal) regulations in trade with third countries. Within the single market the abolition, harmonisation or reciprocal recognition of many and varied national regulations concerning the micro-structures of the interlinked economies are necessary. This constitutes regulatory policy in the widest sense, so that inter alia major parts of the national legislation governing competition, taxation, the environment, health, consumer protection or banking policy - and the related parts of economic, company and social legislation - will have to be regulated at Community level. In addition, there may have to be Community regulations in the fields of regional and industrial policy, since the promotion of individual regions and high-technology production areas must not be left to national initiatives alone in future - as already in the past in some cases. In this connection, Community mechanisms to prevent structural and industrial policy conflicts between individual Community countries are needed. The opening-up of the markets in the context of the single market admittedly permits increasing specialisation, a more productive use of capital and labour, increased competition and the exploitation of the advantages of mass production. But this may also give rise to conflicts resulting from an uneven distribution of productivity-boosting effects or from the fact that individual countries try, by means of non-market measures, to attract particularly profitable and promising economic sectors to themselves.

The harmonisation of micro-economic policies that is required to establish an economic union indirectly has a monetary facet as well: in the absence of an adequate consensus on supply-side conditions and the role of the government, the participating economies may respond in different ways to internal and external disturbances; this may produce distortions in intra-Community current and capital transactions which, in a "hard" economic union, cannot be reflected in a pressure towards exchange rate changes. Vis-à-vis third countries, liberal Community regulations on the exchange of goods and services, the freedom of corporate establishment and of movement for capital and labour will have to be agreed on and applied. In this field, too, the requirements will have to be all the higher, the more the envisaged economic union is to be developed in the direction of a narrow monetary arrangement.

To ensure that the advantages of a common internal market are not jeopardised by inconsistent national monetary and financial policies or income formation processes, an economic union definitely requires some coordination of macro-policies. As already mentioned, the degree of harmonisation necessary ultimately depends on the adjustability of exchange rates. In a "soft" economic union the prime need is the fixing of common economic policy goals or priorities, whereas - for instance, in the EMS - exchange rate adjustments may help in principle to eliminate unavoidable tensions; such tensions may arise, even if the underlying economic policy stance is similar, because the structural and adjustment properties of the member countries still differ greatly in some cases. Persistent divergences in the underlying macro-economic stance of economic policy would lead to output and demand disturbances which hamper the integration process. To this extent, a common internal market necessitates a certain surrender of national economic policy sovereignty, even if exchange rates are not finally fixed.

In the event of a "hard" economic union, an even greater degree and, in particular, a strictly binding coordination of procedural policy are required because the "buffer function" of adjustable exchange rates does not exist here. As wages and prices in all Community countries are flexible to only a limited degree, and in some cases to varying degrees too, in a monetary union not integrated in respect of procedural policy demand and supply shocks emanating from the national market or abroad might trigger sustained quantitative reactions in the individual member countries, which reactions might be reflected inter alia in excess demand or underemployment tendencies. These would enforce consistency in price and cost movements (price reactions) only in the long term, but without ensuring a general equilibrium of parities. Such painful and unforeseeable domestic economic adjustment processes might be more detrimental to the operation of a common internal market than parity adjustments which are made discreetly and in good time. If the system of adjustable exchange rates is abolished, strong divergences in the fundamental economic variables of the member countries must either be prevented from developing or corrected immediately by means of economic policy measures.

3. Taking stock of the state of integration

Viewed from the present perspective, there is still a long way to go until economic union has been achieved. Although a customs union already exists, there are still border controls in intra-Community merchandise transactions, the free carrying-on of an occupation anywhere within the Community is still not possible for numerous occupational groups and there are still restrictions in the field of services (mainly in the areas of transportation and financial services). Nor are capital transactions and payments completely free. Most member states - with the exception of the Federal Republic of Germany, the United Kingdom and the Netherlands - are still applying more or less comprehensive capital controls, individual countries are still resorting to protective clauses to restrict transactions which should have been liberalised long ago in accordance with the existing agreement. The free movement of goods, capital and labour which is an essential element of the realisation of an economic union has therefore not been adequately achieved to date, even though further steps towards liberalisation have been initiated.

In addition, there are numerous discrepancies as regards the policies and regulations governing the micro-structures. Besides discriminations in favour of the national economy (e.g. through public procurement policies, differing industrial standards, environmental and consumer protection regulations), there are still serious differences in competition, structural and regional policies and in the whole field of external economic policy vis-à-vis third countries. This is the point of departure of the programme to complete the single market in 1992, which at the same time embodies the opportunity and the obligation to eliminate the obstacles just outlined as fully as possible.

What is missing from a complete economic union, apart from imperfect realisation in some respects and the structural and foreign trade support afforded by an integrated internal market, is above all an adequate and sustained consensus on the underlying policy stance with respect to the workings of the economy. The convergence registered in the last few years of major macro-economic variables, such as wages, prices or interest rates, cannot disguise the fact that within the partner countries some very different combinations of changes in the price level, growth, employment and foreign balance are considered to be attainable or "optimal". As long as there are no serious conflicts between these goals from the national point of view, coordination at Community level is relatively easy. However, if there are disequilibria in several fields at the same time, conflicts about the priority of individual objectives are highly probable. An example of this is the so-called "asymmetry debate" in the context of the European Monetary System. This shows that there are still substantial imbalances and different conceptions of the appropriate policy-mix.

The economic policy divergences still remaining are complex. Some of them can be related to past experience, rooted in national history, to the traditional role assigned to the government in each case, and to the differing significance of individual institutions and social groups. It is to be assumed that such national "preferences" will converge only very gradually. It is therefore all the more important not to disregard them but to take them into account realistically when establishing an internal market and particularly when trying to come closer to economic and monetary union. The existing Community institutions and coordinating mechanisms are unlikely to be equal to the task of remedying these shortcomings in the integration process quickly. After the initial successes of the EMS, this seems to apply even more to general economic policy (including regional and sectoral structural policies) than to the narrower field of monetary policy. It would therefore be wrong to place emphasis on the monetary integration process in the debate on the institutional aspects of economic and monetary union.

In the rest of this paper an attempt will be made to point out the harmonisation and coordination requirements for major areas of economic policy - requirements which will have to be borne in mind in the future in order to realise a "soft" or "hard" economic union. This is a matter of the two <u>basic</u>

elements of an economic union: on the one hand, the determination of common economic policy goals or priorities in the sense of more or less binding guidelines for procedural policy - in particular, key policy areas such as monetary, fiscal and incomes policy must be addressed in this context; on the other hand, it is a matter of developing ideas consistent with the Community concept in the field of the competitive system and the economic structure - besides general economic policy instruments, specific policy segments which affect economic micro-relations must be discussed here.

4. Integration of key policy areas

a) Monetary policy

The recent debate on increased coordination of the Community's internal and external monetary policy links up with facts - the progressive liberalisation of capital transactions, the adjustable but virtually stable exchange rates in the EMS, the common attitude towards third currencies - which will arise in a similar or stronger form on the completion of a common internal market or the implementation of a "soft" economic union. From my perspective, the degree of monetary policy coordination which has been achieved to date could already be considered in principle to be almost enough to buttress as smooth a functioning as possible of the common internal market. Above all, to implement a "soft" economic union, neither a Community currency nor a European central bank system would be required.

In a "hard" economic union with absolutely fixed parities national monetary policy de facto loses its autonomy or, if a Community currency is introduced, it gives way de jure to a Community central bank system. With this approach, the principles and preconditions to be fulfilled from my point of view will be described in a separate paper[1]. The following detailed remarks are confined to the integration and coordination requirements in non-monetary policy areas.

b) Budgetary policy

In the case of both a "soft" and a "hard" economic union, public financial policy would be affected in two ways:

- In any type of economic union, heavy demands are made on the coordination of financial policy with respect to the use of the public budgets to achieve macro-economic objectives in the context of overall economic management. It has to be ensured that the member states cannot pursue, in the areas of cyclical policy and growth policy, conflicting financial policy strategies which would obstruct each other or lead to intra-Community imbalances. In the event of more far-reaching integration, a particular measure of agreement on the basic financial policy stance is required, if only because attempts by major member countries to be a financial policy "lone wolf" also affect the current account situation and exchange rate position of the entire Community vis-à-vis third countries.

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1 See also: Karl Otto Pöhl "A Vision for European Monetary Union", Wall Street Journal (European Edition), July 20, 1988.

- The taxation and expenditure patterns of public finance, to the extent that they affect the economic structure and the movements of goods, capital and labour in the Community, have to be harmonised to a certain degree to prevent them having adverse effects on the single internal market and to increase the economies' micro-economic efficiency. Harmonisation is all the more necessary, the greater the mobility of goods and factors of production is and the faster the exchange rate mechanism is being pushed forward.

In view of the overall control through the public budgets it can be assumed in the case of a "soft" economic union that the central budget of the union itself will be comparatively small in volume. If, furthermore, its expenditure pattern is biased towards one sector - as currently in the EC - and if credit financing is not permitted, the union's budget is hardly suited from the outset for exerting direct influence on economic activity. The member states' financial policies would thus require coordination extending beyond the existing guidelines. This coordination would have to be in line with a medium-term strategy. Whether shorter-term economic policy goals could be pursued would depend on the given situation. Common goals could be justified only if the cyclical situation in the Community was uniform, otherwise they might be counterproductive. If the starting positions differ, some room for manoeuvre could be conceded to the member states for individual "policy mixes" of monetary and financial policy.

In the further development towards a "hard" economic union the overall control could shift slightly more towards the union's central budget, because it is to be expected that further government functions will be assigned to the central budget (say, in the field of infrastructure projects of European scope, in regional policy, in research and development, in the field of social policy and possibly in the defence area too). This would necessarily involve greater revenue responsibilities, and possibly also the right to borrow in the market (not from the European central bank). Nevertheless, the main burden of the cyclical and growth policies would presumably still have to be borne by the member states' budgets. This requires a stricter integration in a basic stance tailored to the needs of the union than is necessary in the "softer" stage of integration, primarily in order to avoid from the outset excessive strains on the exchange-rate-stabilising function of monetary policy, which is now being conducted centrally. Coordination of the member states' financial policies may also have to include specific elements of the public budgets (such as size of the deficits, variation of certain expenditure items and taxes, debt management compatible with the Community). But central commitments are required only to the extent that this appears to be necessary for the overall economic development aimed at in the union. For the rest, the member states' autonomy can be retained, in much the same way as more or less independence is conceded to the individual states of federations in the financial policy field.

The coordination of the financial policy parameters which influence the economic structure, as for instance in the field of the tax and social systems, generally need not be as comprehensive as in the case of the Community-oriented financial policy "overall economic management". If only because of the differing states of economic development of the individual member countries, deviations in the tax burden and in the level of the social benefits are not only justified economically but to a certain extent actually imperative in order to set reasonable limits from the outset to the volume of financial transfer payments within the Community. For example, less developed countries need lower wage costs as well as advantages with respect to the tax burden if they wish to make up economic leeway. On the other hand, competitiveness is influenced by many locational factors, of which taxes and social security contributions are only a part. Harmonisation is indispensable, however, to the extent that it permits the dismantling of existing border controls within the Community and thus makes possible the completion of a single internal market with free movements of goods and services, individuals and capital. Tax-induced shifts in competition can be tolerated within certain limits and offset by means of exchange rate changes. However, this scope for deviations in taxation becomes all the smaller, the more the Community approaches a "hard" economic union in which exchange rate adjustments are no longer possible.

A relaxation of border controls between the member countries presupposes a certain degree of harmonisation of indirect taxes for which so far a "monetary compensation" has been made - by reducing the tax burden on exports or increasing it on imports. The greatest significance attaches in this context to value-added tax, where cross-border deliveries within the union will have to be treated in future in the same way as sales within a member state. This could be achieved by introducing a cross-border prior tax deduction.

For turnover between enterprises liable to value-added tax, differences in tax rates between individual member countries would then have no impact on competitive conditions. Shifts in competition would result only to the extent that there would be an incentive to import direct from "low-tax countries" and that these countries would become attractive as locations for mail order firms. The scope for evasive reactions would however be narrowed by additional costs (above all transport costs) and would probably be of significance only for high-quality consumer durables and in densely populated border regions. Discrepancies in turnover tax rates, within certain margins, therefore seem to be acceptable even in a "hard" economic union, as is shown by experience in the United States (where "sales taxes" differ greatly, even between neighbouring states). For special excise taxes, certain differences in tax rates are likewise possible in a European economic union, if transport costs are taken into account, without this giving rise to serious distortions in competition.

Owing to the relatively low mobility of earners, harmonisation of direct taxes is less necessary than harmonisation of - product-related - indirect taxes. However, the total tax burden, which includes this component too, is of significance for the competitive position. In this respect Germany is in a midfield position in the EC, rather like France, the United Kingdom and Italy. It remains to be examined, however, whether enterprises' tax burden should not be adjusted to international conditions for competitive reasons.

With a progressive approach to an economic and monetary union, financial compensation payments to economically weaker regions and less developed countries are likely to increase in significance (see section 5b below). Hence, as already suggested, the budgets of the member countries should take the differences in the economic structure into account as far as possible, and not be adjusted to them purely formally. Attention must be drawn explicitly to this budgetary aspect of the integration process at this juncture, as the possible scale of future regional conflicts is often underrated, particularly in a "hard" economic union which is implemented at an early date. The nature and size of the financial compensation to be provided here could be among the most controversial financial policy issues which the integration process raises.

c) Policies in the field of income formation

The trend in wages and unit labour costs in the EC countries in the last few years has been marked by improved convergence, while cost and price rises have generally slackened. This tendency has undoubtedly been fostered by exogenous influences, such as the downturn in oil prices; in addition, increased stabilisation efforts on the part of individual governments seem to have played a part. Tendencies - which are gratifying from the German point of view - towards reducing or completely eliminating direct intervention in the wage and price formation process and wage indexation mechanisms have gained the upper hand (United Kingdom, France, Italy). At the same time, extreme wage increases agreed by management and labour, which would have fostered inflation, have largely been avoided. Traditional incomes policy has largely given way to governments exercising influence on the macro-economic, organisational, tax and social policy framework of wage and price formation, while wages themselves are being left to management and labour. Many of the integration functions to be performed in this field are therefore in the hands of the European trade unions and trade associations and cannot be discharged by public authorities alone in future.

In a "soft" economic union the objective of the Community must be to further improve the degree of convergence already achieved in order to minimise in this way the inflationary tensions in the income formation process which would hamper the implementation of an internal market. At such a stage, exchange rate adjustments would still be a "stopgap solution" to neutralise changes in competitiveness owing, say, to diverging trends in unit labour costs in individual countries. In this connection, attention should be drawn not only to pay rate increases which cannot be justified economically but also to discrepancies in the movement of additional wage components (social security contributions to unemployment, health and pension insurance) and non-tariff wage cost components (social plans, dismissal protection, etc.), for which the public authorities are responsible.

In a system of finally fixed exchange rates in which unbalanced competitive conditions on the wage side can no longer be "cured" by realignments, other stabilisation and adjustment mechanisms would have to perform the task of correction:

- In principle, European management and labour would have to be prepared to gear their wage policy largely to productivity improvements and to accept a uniform, minimal rate of price increase at the Community level.

- Once cross-border freedom of movement has been achieved, those factors of production which are highly mobile will leave countries with comparatively unfavourable production costs and go to regions with a higher return on fixed capital. This will no doubt apply primarily to the factor capital and particularly to qualified labour. This leads to a certain disciplining pressure in the direction of greater wage differentials, which the social groups would have to tolerate. Ideally, the rise in wages in countries with comparative cost disadvantages should therefore lag behind the increase in the Community average from the outset, if employment in the former countries is to be maintained despite a declining or less rapidly expanding demand for goods or if shifts in demand necessitate new production and wage patterns. In this way, competitive disadvantages could be mitigated or eliminated altogether through the adjustment of wages. Wage flexibility would thus have to take over a good deal of the role hitherto played by exchange rate adjustments. If this failed to happen, regional discrepancies in economic activity would not decrease but might even increase.

5. Harmonisation of particular micro-economic policy areas

a) Regulatory and competition policies

Broadly speaking, a common competition policy presupposes that, not later than the stage of a "hard" economic union the member countries have fully compatible regulatory basic ideas about the role of the government in economic activity. In this respect national predilections still diverge widely in some cases. This applies, firstly, to internal conditions in the Community, particularly where the role of state enterprises, the extent of government control in sectoral and regional development and the realisation of competition protected against private monopoly influences are concerned. As regards the design of the Community's external relations (see section 6), it is not altogether clear to what extent liberal or protectionist elements will predominate in the end.

In the narrower field of public competition rules it is mainly the question of the control of private market power which arises in connection with the development of a single internal market. With further progress towards integration, European cartel agreements and corporate mergers will increasingly have to be expected. An economic union would necessitate a reinforced - preventive - competition policy which - as in the United States and in most member countries - is given a chance to prevent a market-dominating position from arising - e.g. by monitoring mergers. Not the least of the reasons why a competition policy of this kind is necessary is that the advantages resulting from the opening-up of the internal market should be distributed as uniformly as possible, i.e. not one-sidedly in favour of enterprises.

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b) Regional and structural policies

Between the highly developed and the structurally weak regions in the European Community there is a great difference in prosperity which is much more marked than the regional differences in the United States, for example. It is a matter not only of the differential between the border areas and the central regions within the individual member states but also of the socio-economic gap between the "mature" central European economies and the peripheral "catching-up countries" as a whole. Here, if not before, the question of the possible speed of the entire integration process arises, unless the risk of the member countries developing further or converging at different rates is to be incurred from the outset. In a "soft" economic union the consequences of the international economic differential - such as the centripetal migrations of capital and qualified labour (which are hard to tolerate socially) and the "demonstration effects" of the high standard of wages and social benefits at the "centre" on the peripheral countries - are mitigated by the "hinge" of adjustable exchange rates; once the parities were finally fixed, however, the structural and growth policy conflicts between the countries of the European "central region" and those of the "periphery" would increase and intra-Community balance of payments problems would emerge as regional disequilibria. Incidentally, it should not be overlooked that the highly developed economies in the Community also include regions with considerable structural weaknesses. They are due to the fact that industries which have been shrinking in the wake of the world-wide structural changes (mining, steel industry, shipbuilding) are concentrated there. From this point of view, today's regional policy in the Community can largely be equated with structural policy.

The vision of a convergence of living conditions in Europe is associated with the idea of an economic union. In view of the inter-regional prosperity differential, the governing bodies of the Community therefore have the task of reducing these discrepancies by means of a regional and structural policy pursued at the European level. Basically, such a policy is already embodied in the regional and structural funds included in the EC budget. The resources of these funds would have to be considerably increased, particularly upon the commencement of a "hard" economic union with its heavier compensation claims. In addition, it may be necessary to envisage comprehensive horizontal financial compensation between the member states (see section 4b above) if "rich" and "catching-up" countries are linked by fixed parities at an early date.

The realisation of the prosperity-boosting effects of an economic union presupposes structural adjustments which make it possible to actually exploit the potential comparative advantages. This implies not least that the production of goods in particular regions or in particular sectors has to be given up if it is possible at lower cost elsewhere. It would mean that the common regional and structural policies were being misunderstood if, say, an attempt were made to maintain in principle such production facilities by means of Community subsidies, thus impeding the necessary structural change, i.e. introducing a policy which has already been pursued in some major industrial countries - where the regional differentials are sometimes pronounced.

c) Environmental protection policy

There are at present considerable differences between the EC countries in the field of environmental protection; these differences are due not only to the prosperity gap but also to the varying political significance that is attached to environmental problems. According to information from the Institute of the German Economy, in the field of goods production, for instance, where European locational questions are affected, the extra investment cost of refineries caused by the relevant legal regulations were five times, and the operating cost caused by obligations imposed to protect the environment was three times, higher in Germany than in Belgium, France, Italy and the Netherlands. Differing environmental protection provisions at the product level, e.g. for motor vehicles, would lead to a split in the single internal market. This would be contrary to the purpose of an economic union. To this extent, a standardisation of the environmental protection regulations appears to be indispensable to the functioning of the common internal market in the long run. From the German point of view, harmonisation at the comparatively high German level would seem to be desirable.

6. External status of the economic union

An open trade policy vis-à-vis third countries is a key element in internal market integration. All European countries are interlinked with the rest of the world and rely on a viable international division of labour. The EC should therefore, on the one hand, actively support a strengthening of the multilateral open trade system, and particularly a successful conclusion of the Uruguay Round. On the other hand, it should not provide a pretext for protectionist measures in other countries by its own approach to the completion of the single market.

In practice, this means that access to the market by goods and enterprises from third countries must not be artificially restricted. Adjustment problems within the EC, which are to be expected as a result of the more intense competition on the single market, should not be "solved" at the expense of suppliers from third countries. In particular, in formulating a common trade policy the Community should not orientate itself towards the member country with the highest "degree of protectionism", but it should let itself be guided in its external relations too by the basic principles of a market economy. The agreed liberalisation of capital transactions on the "erga omnes" principle could to this extent serve as a model for the exchange of goods and services with third countries. In addition, exaggerated expectations of reciprocity should not be entertained when admitting foreign enterprises and financial institutions to the internal market, even though it will scarcely be possible to dispense with reciprocity completely owing to the differences in national regulations.

7. Institutional requirements of the economic union and transitional problems

The development of Community institutions must keep pace with integration in the economic field, which is to proceed progressively or in stages. Inadequate further development of the decision-making mechanisms and bodies at the Community level would not only complicate and delay the integration process politically but above all adversely affect the credibility of integration measures and the final goal of economic and monetary union in the market's eyes.

Even in the "soft" form of the economic union, market participants must have enough confidence in the irreversibility of the integration process if the advantages of the single internal market are to make themselves felt in full in the long-term decisions of enterprises and households, for example in direct investment or factor movements. During the progressive implementation of economic and monetary union there must therefore be no "power vacuum" or "confusion of responsibilities" in the transitional period.

Compared with the establishment of a "soft" economic union, final entry into a monetary union with definitively fixed exchange rates requires a much higher degree of credibility: a monetary union can function smoothly only if - as noted above - the member states' overall economic policy has been coordinated to such an extent that the market can virtually exclude parity adjustments and that regional disparities can be limited effectively or mitigated by government transfer payments. The coordination of key economic policy areas required for such an economic and monetary union can in principle be achieved by regularly renewed agreements between the partners, by their actual behaviour or by agreed formal "ground rules" (e.g. compatible monetary targets). However, not least in view of market participants' confidence in the irreversibility of the integration process, a purely "pragmatic" coordination of national economic policies would be less promising than the explicit transfer of broad decision-making powers to Community bodies, which would moreover confer on the Community an "economic policy identity" at the same time.

In the light of the need for balanced progress of the integration process, at every stage of the transition to a "soft" or "hard" economic union it appears to be important that the development of efficient Community decision-making mechanisms and transfers of responsibility to central EC bodies for key economic policy areas should take place "in step". In some sectors (transportation, agriculture) and regulatory problem areas (competition, international trade) economic policy decisions are already being taken by the Community. In other fields, such as social issues, the environment and regional and structural policy, the Community bears a co-responsibility. So far, however, the macro-economic coordination of general economic, financial and monetary policies has turned out to be the "hard core" of the economic policy integration problems. In this field national governments, central banks and parliaments find it difficult to coordinate their decisions and resolutions and to devise and implement programmes at the Community level.

Given this not very satisfactory starting position, it would be risky to shift the emphasis one-sidedly to the monetary policy area when creating additional coordinating mechanisms, Community powers and central bodies. In this field there are already, in the context of the EMS and its progress so far, coordinating pressures and rules (intervention obligations, credit facilities, etc.) which go far beyond the member states' approaches to coordinated budgetary policy.

For the rest, when establishing additional Community powers to implement an economic and monetary union, some difficult legal questions have to be clarified; these include the interpretation of the relevant standards of the EEC Treaty and the democratic authority of the EC governing bodies. From my point of view, the following problem areas should receive particular attention in the light of legal - but also basic economic policy - considerations:

- A European central bank system envisaged in a "hard" economic union would have to be committed primarily to the objective of price stability; it would have to have a maximum of political independence from national governments and Community bodies and have a federative structure. For such a solution it remains to be examined to what extent it can be embodied in national and Community legislation, particularly if the final stage of an economic and monetary union is aimed for before the advent of a political union in Europe.

- A financial policy stance by the member countries that conforms to the Community economic policy stance, which will be imperative on the transition to a "hard" economic union, can probably only be achieved with a relatively strong central body for public budgetary policy. When extending Community decision-making powers in such a way, the federative structure of the public sector in Germany has to be taken into account. In extending the EC bodies' budgetary policy powers this raises difficult constitutional questions with respect to the legislative and administrative responsibilities of the Federal and Länder Governments.

- To safeguard common stability, structural, regional and intra-Community development policies, it will no doubt be necessary for the member states to aim for a common regulatory and social policy framework for the participation of management and labour in the process of income formation and in the sectoral and regional design of wage patterns. From the German standpoint, a market-oriented regulatory framework would have to be provided for this, in which great importance attaches to the principle of autonomous wage bargaining by management and labour and voluntary willingness to cooperate on the part of the trade unions.

- Parallel to the surrenders of sovereignty by the member states in both general and specific economic policy issues, the legislature would have to be strengthened at the Community level in order to ensure that shifts of responsibility in favour of the supra-national level do not result in a loss of democratic authority in the Community. In the final analysis, this might mean that the progressive implementation of a "hard" economic union leads more or less inevitably to a development towards political union.