AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON, D. C. 20523
BIBLIOGRAPHIC INPUT SHEET

FOR AID USE ONLY
Batch 39

1. SUBJECT CLASSIFICATION	A. PRIMARY TEMPORARY
	B. SECONDARY

2. TITLE AND SUBTITLE
The integration of capital markets in Europe: a step towards political unification

3. AUTHOR(S)
Schmitt,H.O.

4. DOCUMENT DATE	5. NUMBER OF PAGES	6. ARC NUMBER
1966	43p.	ARC EU338.914.S355a

7. REFERENCE ORGANIZATION NAME AND ADDRESS
Wis.

8. SUPPLEMENTARY NOTES *(Sponsoring Organization, Publishers, Availability)*

9. ABSTRACT

(Economics R & D)

10. CONTROL NUMBER	11. PRICE OF DOCUMENT
PN-AAC-436	

12. DESCRIPTORS	13. PROJECT NUMBER
	14. CONTRACT NUMBER CSD-355 Res.
	15. TYPE OF DOCUMENT

AID 590-1 (4-74)

THE INTEGRATION OF CAPITAL MARKETS IN EUROPE

A Step Towards Political Unification

by

HANS O. SCHMITT

RESEARCH PAPER #6
International Bank for
Reconstruction and
Development
University of Wisconsin
January, 1966

SUMMARY OF RESEARCH PAPERS SENT TO AID

Research Paper Number:	Author:	Title:
1	K.C. Sen	"Convergence in Planned Economies" (June, 1965)
2	T. Morgan	"Theory of Error in Centrally-Directed Economic Systems" (August, 1964)
4	E.D. Hawkins	"Job Inflation in Indonesia" (October 1965)
6	H.O. Schmitt	"The Integration of Capital Markets in Europe: A Step Towards Political Unification" (January, 1966)

INTRODUCTION

Summary: The Integration of Capital Markets in Europe: Application to Southeast Asia

I

The expectation that a customs union in Europe will ultimately lead to political unification is based on the so-called "spill-over" effect. This effect operates whenever any step towards integration creates new needs and fresh demands to proceed further in the same direction. Thus a customs union may create pressures to integrate not only commodity, but capital markets as well. An integration of capital markets in turn may necessitate currency unification for its effective functioning, and a unified currency area finally may imply a pooling of sovereignties sufficiently complete to destroy the separate identities of the participating nation states.

This paper argues that a sequence of that sort is in fact one of the mechanisms at work in the European integration process. Trade integration is not likely to prove acceptable except within a context of full scale economic integration. Freer trade will strengthen tendencies towards factor price equalization. As the distribution of income shifts against capital in the poorer regions, the propensity to save will decline there, and the growth rate fall if financial stability is maintained. Thus "core areas"--where capital and technology are already plentiful--would gain at the expense of the periphery. Entrepreneurs and workers at the periphery cannot rationally accept this consequence unless they are themselves free to move to the center to participate in its gains. One of the requirements would be an integrated capital market.

A close intermingling of claims and liabilities in a single capital market requires a single currency to eliminate exchange risks. The political significance of money derives from the fact that it cannot exist without a set of individual producers accepting a collective identity. For if each producer issues his own currency, in terms of which he prices his product, the distinction between a currency depreciation and an individual price fall disappears. Money itself would then have given way to barter. But once several producers have joined in a single currency arrangement, they may, by a depreciation of the exchange rate, respond collectively to a fall in the external demand for any one of their products.

The option of such a collective response to economic adversity would be destroyed by a common currency. Producers would henceforth have to meet in the Common Market as individuals only, assuming a national identity only toward third countries. If in fact this fusion of national identities is not intended, the customs union must also be called in question. For by itself, it clearly creates tensions that cannot be resolved except by moving forward in the direction of political union--or else by giving up the enterprise altogether. For no inevitability can be ascribed to the "spill-over" process. Precisely at the point where the creation of a common currency comes to threaten the foundations of sovereignty, the impulse to withdraw may well be strongest.

II

A discussion of prospects for economic cooperation in Southeast Asia must first make clear to whom such cooperation is likely to yield political advantages. Arguments based on economic welfare--even if they can be consistently formulated--are not likely to carry decisive weight in actual decision making.

The major interest groups, that just now might have a political stake in regional solidarity, are the business communities in the various countries under consideration. Hard pressed as they are in Burma and Indonesia as well as in Vietnam, they would do well to cooperate for mutual strengthening throughout the region. The question is--how?

A. The closest form of cooperation would be in a currency union.[1] Precedents exist for this sort of arrangement in the East African currency borad, the CFA franc in French West Africa, and in Southeast Asia itself, in the former Currency Board for Malaya and British Borneo. Recently efforts have been initiated to create a common currency for a number of Central American republics as well.

The ease with which common currencies were introduced in colonial and similar areas stands in sharp contrast with the extraordinary difficulty of creating one for theEuropean Economic Community. The explanation probably lies in the fact that a currency belongs to a specific business community. The relevant community in the colonial areas was that of the metropolitan country--which simultaneoulsy operated in several colonies and, under various guises, brought its own single currency to all.

In Europe, however, the problem is first to create a single community out of several, on which a common currency can then be based. Similarly, a common currency in Southeast Asia, if one is to develop, must be based on business communities indigenous to the region, not on a perpetuation, however camouflaged, of the earlier colonial relationship. Is it realistic to expect them to draw together on the European pattern?

B. Economic integration is a "nuclear process" in the sense that larger communities tend to crystallize around "core areas" where capital

---

[1] Hans O. Schmitt, "Political Conditions for International Currency Reform," International Organization, Summer 1964.

and technology are plentiful.[2] In Europe, this process currently centers on the Ruhr. What core area could fulfill a similar function in Southeast Asia?

Singapore as a commercial, financial, and progressively also industrial center, seemed for a while to be a candidate. In fact, it could have been argued that the Malaysian Federation was the first visible evidence that a "nuclear process" focussed on Singapore had begun. The Indonesian "confrontation" campaign can still be seen as a defensive reaction to that possibility.

Had that process gained momentum, it could have shown itself next in a strengthening of separatist sentiment in Sumatra, and possibly in Sulawesi. It was in these areas that the 1957/58 rebellions against the Sukarno regime were strongest.[3] The possibility of joining a loose, but economically viable, Malaysian Federation would at that time have greatly enhanced their prospects of success.

But was the Malaysian Federation ever viable, independent of the British presence? The fact that the "entrepreneurial" elite on which it was based is ethnically mainly Chinese, makes this a questionable proposition for an otherwise predominantly Malay region. In fact, though the Indonesian campaign to "crush Malaysia" has been a military failure, racial tensions within it soon led to threats that "if the Chinese push too hard, the Malayswill turn to Indonesia" (The Economist, June 5, 1965, p.1139).

---

[2] Karl W. Deutsch, Political Community in the North Atlantic Area, Princeton, 1957.

[3] Hans O. Schmitt, "Foreign Capital and Social Conflict in Indonesia," Economic Development and Cultural Change, April, 1962.

C. The insecurity of the Singapore business community would in any case have contributed to other factors drawing capital away from the region, a process that Singapore's financial sophisticiation would do more to expedite than to hinder. Abadoning any hope for an agglomerative process in Southeast Asia, then, is it perhaps still possible to advocate a widening of Southeast Asian markets through lowered barriers to regional commodity trade? Though restrictions on capital account would continue, such an arrangement could still aim to realize economies of scale that would otherwise create barriers to investment even on a national basis.

Unfortunately, trade "integration" is not likely to prove acceptable except within a context of full scale economic integration.[4] For freer trade will strengthen tendencies toward factor price equalization. As the distribution of income shifts against capital in the poorer regions, the propensity to save will decline there, and the growth rate fall if financial stability is maintained. Thus "core area"--where capital and technology are already plentiful--would still gain at the expense of the periphery. Entrepreneurs and workers at the periphery cannot rationally accept this consequence unless they are themselves free to move to the center to participate in its gains.

D. Neither a "free trade area" nor a common market, therefore, let alone a common currency, seem likely prospects in Southeast Asia. There remains a last possibility, something on the pattern of the O.E.E.C. in Europe, similarly based on large-scale foreign aid from abroad. The organizational form such aid should take must be carefully adapted to the posited goal of strengthening business communities in the region.

---

[4] Ibid.

Most worth investigating perhaps is the creation of a regional development bank on the pattern of the International Finance Corporation rather than of the World Bank itself. The I.F.C. grants loans and participates in the capital specifically of private enterprises, without so much as a government guarantee.

The business communities in the region should probably themselves contribute a major portion of the capital of a Southeast Asian Finance Corporation in order to make it the focus of a common effort at mutual support in the face of a skeptical if not hostile environment. Foreign aid could then give this effort considerable encouragement, perhaps by matching whatever capital is raised locally.

E. We have defined four possible ways of organizing cooperation in Southeast Asia: a common currency, a common market characterized by a free flow of resources, a free trade arrangement with continuing barriers on capital account, and a regional development bank. The problems encountered in Europe in the effort of moving from the last of these to the first suggest that at this stage only the last offers sufficient hope of success to be seriously considered in Southeast Asia. But that is only a hypothesis to be investigated at this stage, not a conclusion based on a completed investigation.

THE INTEGRATION OF CAPITAL MARKETS IN EUROPE

A Step Towards Political Unification

Hans O. Schmitt

The expectation that a customs union in Europe will ultimately lead to political unification is based on the so-called "spill-over" effect.[1] This effect operates whenever any step towards integration creeates new needs and fresh demands to proceed further in the same direction. Thus a customs union may create pressures to integrate not only commodity, but capital markets as well. An integration of capital markets in turn may necessitate currency unification for its effective functioning, and a unified currency area finally may imply a pooling of sovereignties sufficiently complete to destroy the separate identities of the participating nation states.

This paper argues that a sequence of that sort is in fact one of the mechanisms at work in the European integration process. Two remarks should however be made at the outset. First, other similar processes can certainly be identified. Thus a growing interest in a common currency may come from labor as well--as a greater mobility exposes workers to exchange risks on home remittances; and from agriculture--insofar as defining administered prices in units of account will make currency adjustments more awkward than before.[2] These pressures are unlikely to be decisive, however, unless a

---

HANS O. SCHMITT is Associate Professor of Economics at the University of Wisconsin. He is indebted to Benjamin J. Cohen, Allen C. Kelley, Charles Kindleberger, Theodore Morgan, and Seiji Naya for comments and criticism, and to the U.S. Agency for International Development for financial support.

[1] See Ernst B. Haas, "International Integration: The European and the Universal Process," International Organization (Summer 1961); and Leon N. Lindberg, The Political Dynamics of European Economic Integration (Stanford: 1963), pp.10-13.

[2] Opera Mundi Europe (January 21, 1965), pp.7-8.

similar interest arises within the business community itself. Hence the special focus here on capital markets.

Second, no inevitability should be ascribed to any of the possible spill-over effects. Especially at the point of creating a common currency, the temptation to draw back may well be strongest, inasmuch as an independent currency lies close to the roots of sovereignty.[3] What the spill-over process implies instead is the ultimate inconsistency of a customs union and political separatism, so that if political unification is rejected in the end, the customs union will have to be scuttled also. Whether it will be or not depends on how strong a vested interest in the customs union has been allowed to develop before the final challenge to national sovereignty is made.

The role of capital markets in the spill-over process is traced out with reference to three questions: (1) To whom will an integration of capital markets become necessary if a customs union is to function effectively; (2) how far has the integration of capital markets progressed, and what specifically are the obstacles to further advance; and (3) in what way will a liberalization of capital movements induce a concentration of financial policy in the Community? The first question will focus attention on economic trends, the second on institutional adjustments required by them, and the third on the consequences for policy.

TRENDS

The Treaty of Rome envisions, in addition to a customs union, "the abolition, as between Member States, of obstacles to the free movement

---

[3]See Hans O. Schmitt, "Political Conditions for International Currency Reform," International Organization (Summer 1964).

of persons, services, and capital."[4] But though precise commitments on the free movement of persons and commodities were required, the Treaty includes no explicit ruling on either the extent or speed of capital market integration.

In the course of the transitional period,[5] member states are progressively to abolish restrictions on the movement of capital belonging to residents of the Community and to eliminate any discrimination based on their nationality--but only to "the extent necessary for the proper functioning of the Common Market."[6] To this nd, the authorities shall "endeavor to avoid" introducing new exchange restrictions,[7] and grant exchange permits "in the most liberal manner possible."[8] In effect, therefore, the authors of the Treaty relied for a liberalization of capital movements on demands generated by the integration process in other sectors.

For whom, then, will an integration of capital markets become necessary, if a customs union is to function "properly?" It would have to be an interest otherwise damaged by the customs union alone.

Trade expansion injures the scarce factor

A purely economic case for factor movements in a customs union argues that allocative efficiency is apt to remain incomplete without them. Maximum efficiency in the allocation of resources is said to be attained when

---

[4] Treaty of Rome, Article 3(2).

[5] The transitional period was expected to take 12 years, from 1958 to 1970, divided into three stagesof four years each. Ibid., Article 8(1).

[6] Ibid., Article 67(1).

[7] Ibid., Article 71.

[8] Ibid., Article 68(1).

the marginal products and rates of return for each factor are the same in all employments--in all industries and in all locations. For once such an equilibrium is attained, no new shifts of resources can produce any further gains in output or reductions in cost.

Free commodity trade preseumably creates tendencies towards an equalization of factor prices between countries even without factor movements.[9] As each country specializes in those products that require more of its abundant and therefore cheap factors, the demand for them and their prices will increase. As it reduces the output of those industries that use larger proportions of its scarce and expensive factors, their prices correspondingly fall. The distribution of income will therefore shift in favor of capital where capital-labor ratios are high, and against it where they are low.[10]

As a result, the scarce factor is clearly injured. That is to say, business communities will be weakened by tariff cuts in regions where capital accumulation has been weak, and strengthened where it has been strong. If wage levels are an indication of relative labor scarcity, then Table 1. would lead us to expect the business climate to deteriorate

---

[9] See for example Paul A. Samuelson, "International Trade and the Equalization of Factor Prices," Economic Journal (June 1948).

[10] A conventional formulation of the inverse relationship between relative factor supply and factor cost conventionally begins by making output X depend on capital K and labor L as follows:

$$X = AK^{a}L^{1-a} \qquad (1)$$

where the scale factor A is a positive constant greater than one, and the exponent a a positive constant less than one-half. Under competitive conditions, the marginal products and rates of return of capital and labor will be, respectively:

$$dX/dK = aA\left(\frac{L}{K}\right)^{1-a} \qquad (2a)$$

$$dX/dL = (1-a)A\left(\frac{K}{L}\right)^{a} \qquad (2b)$$

To show the plausibility of European developments, this formulation will presently have to be amended.

Table 1.

Hourly Wages in European Manufacturing*

in U.S. dollars
at current exchange rates

	1960	1962
Germany	.64	.83
Belgium	.67	.74
France	.53	.62
Netherlands	.51	.66
Italy	.37	.46

*Two years are shown to indicate the slight effect of the German and Dutch revaluations of 1961 on the ranking of countries by wage rates.

Source: computed from Statistisches Jahrbuch fuer die Bundesrepublik Deutschland 1964 (Wiesbaden: 1964), pp.129ff.

especially in Italy, but improve perhaps most in Germany, as the effects of the customs union work themselves out over time. This will in fact turn out to have been the case.

Even without deliberate protection, however, equalization is not expected to be complete as a result of trade alone.[11] Transport costs may for example provide a natural insultation. In addition, there may also be more subfactors of production, each with its own price, than there are products to discriminate between them in commodity markets. Or else, the whole supply of a particular factor may be absorbed in an expanding industry before equalization has run its full course, making further increases in the price offered to it pointless. Some additional contribution to allocative efficiency is therefore to be expected from factor movements. But whose interests, specifically, are furthered by them?

Capital escapes injury by migration

[11]See for example James E. Meade, Problems of Economic Union (London: 1953), pp.56ff.

If capital were to move in the direction of plentiful labor supplies, it would merely add to the deterioration of the business climate there. But the allocation of American direct investment shown in Table 2., by favoring Germany more than a mere difference in size would justify, suggests an opposite tendency. Other factors besides labor must therefore render capital scarce. Economies of agglomeration are perhaps the most significant of these.[12]

Table 2.

U.S. Direct Investment in European Manufactures, relative to G.N.P.

	G.N.P. in $ billions	millions of U.S. dollars invested			
	1962	1962	1963	1964*	1965*
Germany	88.7	361	261	319	335
Belgium-Luxembourg	13.0	26	38	48	35
France	72.7	100	110	121	133
Netherlands	13.4	22	36	35	37
Italy	39.9	39	89	61	52

*Figures estimated on the basis of company projections

Sources: Statistical Office of the European Communities, Basic Statistics of the Community (Brussels: 1964), p.23; and U.S. Department of Commerce, Survey of Current Business (Washington: 1964), p.10.

Initially, industry may be attracted to a particular region because it offers a ready supply of essential raw materials, such as coal and iron in the industrial heartland of Europe centering on the Ruhr. But once industry has established itself, further cost reductions are possible due to the development of power, transport, and marketing facilities, of specialized technical equipment to service several industries at once, of

[12] Cf. Francois Perroux, "Note sur la notion de pole de croissance," Economie Applique (January-June 1955); and W. Isard and E.W. Schooler, "Industrial Complex Analysis, Agglomerative Economies, and Regional Development," Journal of Regional Science (September 1959).

labor skills and organization, and especially of research and development potential for the discovery and installation of new technology to make both labor and capital progressively more productive.[13]

In consequence, higher returns cause both labor and capital to gravitate to areas where capital and technology are already highly concentrated. Significantly, it was around such "core areas," too, that nation

---

[13]Introducing economies of agglomeration into the simplest possible model in the simplest possible way, we can modify the conventional production function by writing:

$$X = A^{K/Q} K^{a} L^{1-a} \qquad (3)$$

where the scale factor A is now made into a positive function of the concentration of capital K over some given space Q. The marginal product of labor continues to show diminishing returns in spite of the change, but the marginal product of capital no longer does. While the rate of return to capital can therefore no longer be equal to its marginal product, the equilibrium wage under competitive conditions can still be identified as:

$$dX/dL = (1-a)A^{K/Q}\left(\frac{K}{L}\right)^{a} \qquad (4a)$$

The profit rate must then be equal to the residual share of income divided by the capital stock, or:

$$p = aA^{K/Q}\left(\frac{L}{K}\right)^{1-a} \qquad (4b)$$

Taking the derivative of (4b) with respect to capital K, we get:

$$dp/dK = a\left(\frac{a-1}{K} + \frac{\log A}{Q}\right)A^{K/Q}\left(\frac{L}{K}\right)^{1-a} \qquad (5)$$

The only negative term is (a-1) just inside the first bracket, but the first bracket as a whole turns positive as soon as:

$$\frac{K}{Q} > \frac{1-a}{\log A} \qquad (6)$$

Once the whole expression is positive, the rate of profit turns into a positive, no longer a negative function of the capital-labor ratio.

states have tended to crystallize in the past.[14]

Where capital and technology together are scarce, trade expansion alone is still likely to injure capital.[15] But with factor mobility, capital can now escape the pressure of rising wages at the periphery, by migrating along with labor to centers of growth and participating in the expansion there. As long as total output is increased thereby, efficiecy will have been improved by it. But of course the loss of capital and labor will at the same time have weakened the periphery as an entity relative to the center in productive power and political influence.

Resource losses require a political response

The Treaty requires that restrictions on the right of establishment anywhere in the Community be abolished in the course of the transitional period.[16]

---

[14] See Karl W. Deutsch, "The Growth of Nations: Some Recurrent Patterns of Political and Social Integration," World Politics (January 1953), p.178.

[15] The plausibility of this proposition can be illustrated with the help of the equations in footnote 13. The ratio R of profits to wages can be written as:

$$R = \frac{a}{1-a}\left(\frac{L}{K}\right) \qquad (7)$$

The derivative of this expression with respect to capital is equal to:

$$dR/dK = -\frac{a}{(1-a)}\frac{L}{K^2} \qquad (8)$$

--a negative quantity as long as the exponent a is less than one-half, as it is generally assumed to be. As the capital-labor ratio rises, therefore, capital will still become cheaper relative to labor. Consequently, a capital-rich country will continue to find its comparative advantage in capital-intensive products, and a labor-rich country in labor-intensive ones.

[16] Treaty of Rome, Article 52.

Persistent resource losses can hardly be a matter of political indifference, however, except as the periphery is prepared to abandon its separate political identity in order to participate in a large community.

The pull of economic gain from factor movements--to the individuals to whom they belong--may help to overcome political inhibitions to it.[17] In fact, the push of rising wage costs at the periphery may already have begun in the European Community. As Table 3. shows, increases in wage costs per unit of output slowed down at the center, but markedly accelerated at the

Table 3.

Changes in Labor Costs per Unit of Output, in percentages*

	1960	1961	1962	1963	1964
Germany	3.2	11.2	6.3	1.7	-2.6
Belgium	0	2.7	5.4	4.9	7.9
France	1.2	4.7	6.0	5.9	2.4
Netherlands	0	11.4	7.8	3.6	7.0
Italy	-5.6	1.7	7.1	9.9	5.7

*The underlying series is computed by dividing wage costs per man-hour by output per man-hour in manufacturing.

Source: computed from Helen B. Jung and Rudolf R. Rhomberg, "Prices and Export Performance of Industrial Countries, 1953-1963," International Monetary Fund Staff Papers (July 1965), pp.266-7.

periphery, as the customs union began to take effect. It does not follow, however, that periphery governments will therefore press hardest for a liberalization of capital movements. On the contrary. The very eagerness

---

[17]"We found that amalgamation was always preceded by widespread expectations of joint economic reward for the participating units," Karl W. Deutsch et.al., Political Community in the North Atlantic Area (Princeton: 1957), p.141.

of capital to move may well so threaten their balance of payments that they will have no choice but to insist on caution and control instead.

Anticipating such strains, the Treaty of Rome set up two complementary institutions: the European Investment Bank and the European Social Fund. The Fund's main task is to promote the geographic and occupational mobility of workers in the Community, by meeting up to half of the expenses incurred for the purpose by member governments.[18] In its first two years of operations, in 1962 and 1963, its transactions showed a net flow of $3.6 million from Germany, Belgium and Luxembourg to Italy, France and the Netherlands.[19] The European Investment Bank on the other hand was primarily to help finance projects in the less developed regions of the Community.[20] Sixty-six percent of its investments have therefore been concentrated in Italy, as of the end of 1963, and another sixteen percent in France.[21]

The Bank's resources are inadequate, however, to reverse any general trend of investment in the Common Market.[22] At the start of 1963 it disposed of approximately $337 million as compared with $56 billion for gross

---

[18] The Treaty of Rome, Articles 123 and 125.

[19] European Economic Community, Sixth General Report on the Activities of the Community (Brussels: 1963), p.178; and Seventh General Report on the Activities of the Community (Brussels: 1964), p.211.

[20] Treaty of Rome, Article 130.

[21] Total loans over the period came to $358.3 million. European Investment Bank, Annual Report 1963 (Brussels: 1964), p.59.

[22] The Bank has a subscribed capital of $1 billion, of which 25% is paid in, and borrowing rights from member governments and in private capital markets. Protecal on the Statute of the European Investment Bank, Articles 4(1), 5(2), 6(1), and 22(1).

fixed capital formation in the Community as a whole.[23] The Bank's loans must in any case be extended at market rates of interest only, thus excluding any element of subsidy to counteract market forces. The basic implications of integration thus remain unchallenged. How they are worked out in practice remains to be seen.

INSTITUTIONAL CHANGES

The coordination of measures to implement the Common Market Treaty is entrusted to a Council of Ministers, acting on proposals from the European Economic Commission in Brussels. In questions pertaining to financial integration, where specific provisions are lacking and reliance on the spill-over process is therefore necessary, the Commission must consult a Monetary Committee established by the Treaty, and composed of two representatives from the relevant departments of each member government, and two from the Commission itself.[24]

To the Monetary Committee, a minimum definition of integrated capital markets requires that firms in each member country should have access on equal terms to the savings of all.[25] More than a spilling over of marginal demands and supplies between capital markets is therefore necessary. Only a single set of financial institutions in close communication with each other can ensure that the whole spectrum of investment demand is brought in correspondence with the full range of long-term funds available.[26]

---

[23] European Investment Bank, op. cit., pp.18 and 62.

[24] Treaty of Rome, Article 105(2).

[25] European Economic Community, Fifth Report on the Activities of the Monetary Committee (Brussels, April 5, 1963), p.8.

[26] Charles P. Kindleberger, "European Economic Integration and the Development of a Single Financial Center for Long-term Capital," Weltwirtschaftliches Archiv (Vol. 90, No. 2, 1963), p.191.

Such a set of institutions is found most conveniently in a single financial center.

To make Paris the financial center of the European Community is an explicit aim of French policy.[27] How far, then, has the integration of capital markets gone in the Community, and what specifically are the obstacles to further advance?

<u>Liberalization has been slowest at the periphery</u>

The European Commission has thus far succeeded in having only two Directives approved by the Council of Ministers, one on 11 May 1960, the other on 18 December 1962.[28] Both focussed on the reductinn of exchange restrictions alone. Capital movements were classified into four categories for the purpose, to each of which different provisions were applied. Transactions in the first category, comprising primarily direct investments, were to be liberalized unconditionally. The fourth category includes mainly short-term capital movements, for which by contrast no obligation to liberalize was imposed at all.

The two intermediate categories separated trading in securities listed on stock exchanges from the issue and placement of new foreign securities in national markets, dealings in unquoted securities, and from long and medium term loans. Transactions in the former have also been liberalized "unconditionally," but can still be channeled through "free" exchange

---

[27] Valery Giscard d'Estaing in a speech before the Franco-American Chamber of Commerce on June 30, 1964. <u>The Economist</u> (July 4, 1964), p.73.

[28] <u>Journal Officiel des Communautes Europeennes</u> (Brussels, July 12, 1960), pp.921-932; and <u>Ibid.</u> (Brussels, January 22, 1963), pp.62-75. See also Claudio Sgre, "Capital Movements in the European Economic Community," <u>Banca Nazionale del Lavoro Quarterly Review</u> (March 1962).

markets, as long as governments "endeavor to avoid" excessive discrepancies between free and official exchange rates. For the latter category, only a conditional liberalization was foreseen. Controls can be retained or re-imposed on new issues in the interest of national economic policy.

For Germany and Belgium the new rules brought only a consolidation or previous liberalization measures, in the sense that henceforth there was to be no unilateral going back on them beyond the limits newly set for the Community as a whole.[29] Table 4. shows them to have been steady capital importers. Elsewhere some alignment to new Community standards

Table 4.

Net Overall Private Long-term Capital Imports

annual averages or years
dollar millions

	1960-1962	1962	1963	1964*
Germany	242	286	783	111
Belgium	5	24	30	162
France	359	402	516	527
Netherlands	-65	-35	-16	116
Italy	0	-319	-522	263

*draconian measures, described in the last section, disturbed the patterns in 1964.

Source: European Monetary Agreement, Fifth Annual Report 1963 (Paris: 1964), p.53, and Sixth Annual Report 1964 (Paris: 1965), p.55.

was required. For the Italians and Dutch worried over persistent capital outflows, and the French over the possibility of similar drains if controls were to be relaxed.

Some progress was possible nevertheless. As a concession particulary

---

[29] G. Dermitzel, W. Damm, and K Richebaecher, Das Bankwesen im Gemeinsamen Markt (Baden-Baden: 1962), p.49.

to Italy, the first Directive had allowed transactions in securities as well as direct investment outflows to be restricted to financial institutions, and to companies wishing to acquire securities of foreign enterprises pursuing similar lines of business, up to a ceiling equal to the paid-in capital of the parent company. But the second Directive rescinded this qualification.[30]

At the beginning of 1962 also, following Community advice, separate exchange markets for capital transactions were abolished in France and Italy.[31] Germany never had any. And in Belgium and Holland, where they continue, exchange rates are now rarely permitted to fluctuate beyond margins applicable also to the official rate.[32] By constrast, however, the right to maintain restrictions on new foreign issues continues to be exercised in France and the Netherlands as well as in Italy, though as Table 5. shows, intermittent flotations have by now been allowed in all of them.[33]

The reluctance to open capital markets to new issues, while at the same time permitting transactions in outstanding securities, suggests that barriers other than exchange restrictions may have been relied upon to keep securities transactions within bounds. In a third draft Directive the Commission has therefore linked proposals to free the issue and placement of foreign shares on national markets with the removal of technical and administrative obstacles to (1) the acquisition by financial institutions

---

[30] International Monetary Fund, <u>Fourteenth Annual Report on Exchange Restrictions</u> (Washington, D.C: 1963), p.204.

[31] <u>Ibid.</u>, pp.128, 205.

[32] <u>Fifth Report on the Activities of the Monetary Committee</u>, p.16.

[33] See also Jean O. M. van der Mensbrugghe, "Foreign Issues in Europe," <u>International Monetary Fund Staff Papers</u> (July 1964), p.329.

Table 5.

Net Foreign Issues in Europe and the United States

annual averages or years in billions of current dollars

	1956-1958	1959-1961	1962	1963	1964
United States	0.70	0.70	1.00	1.00	0.80
Germany	0.01	0.03	0.03	0.03	0.23
Belgium	0.02	0.01	0.01	----	n.a.
France	----	----	----	0.01	0.03
Netherlands	-0.01	0.03	0.04	-0.03	-0.01
Italy	----	0.01	0.05	0.02	----
United Kingdom	0.03	0.03	----	0.06	0.17

Source: computed from Bank for International Settlements, Thirty-fourth Annual Report (Basle: 1964), Thirty-fifth Annual Report (Basle: 1965), pp.42 and 42 respectively, and National Bank of Belgium, private communication.

of shares from other member states when payable in the national currency of the purchaser, and (2) to quotations on national stock exchanges of stocks and shares from all member states, which is often essential to attract buyers unfamiliar with conditions abroad.[34]

Exchange risks would continue to be a barrier. Given the turbulent history of European monetary relations, "the traditional European private investor usually prefers investing in his national currency."[35] Still, the expected effect of the Directive on securities arbitrage was sufficient to arouse French concern. To minimize the risk of losing savings abroad,

---

[34] Communauté Economique Européenne, Proposition de Troisième Directive Pour la Mise en Oeuvre de l'Article 67 du Traité (mimeographed, Brussels, April 9, 1964).

[35] Herman J. Abc, "Parallel Loans to Mobilize Continental Funds," The Times (London, March 11, 1964), p.18. See also Tibor Scitovsky, Economic Theory and Western European Integration (London: 1958), p.79.

the French want to limit the quotation of securities to those actually floated on the French market and therefore, like domestic issues, subject to rationing by the Treasury. The Germans and the Belgians, by contrast, have shown themselves anxious to ensure expected gains. They insist that the abolition of exchange restrictions should at the same time be made unconditional in the categories affected by the Directive.[36]

The dollar fills a gap, but at a cost

The common expectation appears to have been that, on laissez-faire principles, the supply of capital would concentrate outside France. The French unwillingness to yield on this point has, however, exposed the Community to the threat of financial domination by established centers outside the Common Market altogether.[37] Though restrictions continue at the short end of the market, for example, excess supplies and demands for short-term funds have been able to spill over into the Euro-dollar market that centers on London.[38]

By taking deposits and making loans in dollars, at margins between the low American and high European lending rates, European banks have taken the lead in developing an efficient international market in short-term funds, abosrbing liquidity from European surplus countries and extending it to those in temporary deficit. According to one estimate, dollar deposits come from

---

[36]Europress report, Brussels, January 16, 1965.

[37]On the distinction between dominance and integration, see Schmitt, op. cit., p.544.

[38]See Paul Einizig, The Euro-Dollar System (New York: 1964), and Bank for International Settlements, Thirty-fourth Annual Report (Basle: 1964), pp.128-142.

at least 25 countries and final users reside in at least 35 countries.[39] Among the approximately 400 banks that participate in the market, the dollar has gone some distance in offsetting the usual localization of financial assets, and is therefore said to have assumed some of the functions of a common currency.[40]

The attraction of the dollar was evident in the market for new issues also. As Table 6. indicates, substantial European issues were drawn to

Table 6.

New European Issues Placed in the U.S.

millions of dollars
before deducting discounts and commissions

		Gross Amount Sold	Non-Resident Portion*
1960		50	26
1961		82	26
1962		273	75
1963:	first half	285	63
	second half	69	16
1964:	first half**	15	6

*"probably European for the most part."
**preliminary

Source: U.S. Department of Commerce, Survey of Current Business (Washington, August, 1964), pp.8,12.

New York, in large part to be taken up again by European buyers, at least until the middle of 1963. The scale of the New York market may have been its chief attraction: wide ownership and active trading offered excellent marketability, and liquidity to investors in a currency, furthermore, whose

---

[39] Oscar L. Altman, "Euro-Dollars: Some Further Comments," International Monetary Fund Staff Papers (March 1965).

[40] See Benjamin J. Cohen, "The Euro-dollar, The Common Market, and Currency Unification," Journal of Finance (December 1963); and Claudio Segre, "Financial Markets in the E.E.C: Prospects for Integration," Moorgate and Wall Street (Autumn 1963).

purchasing power was reasonably constant over a larger national product than any other currency could command.[41]

A projection was therefore ventured that "New York is the most likely center of long-term financial integration for Europe."[42] Its head start over any potential rival, it was thought, could not be overcome. As with the idea of the indivisibility of Atlantic defense, of course, a single Atlantic capital market would not merely place constraints on a distinctively European Community, but in all probability thwart its development altogether. For like the proposed "multilateral nuclear force," it would link the Europeans not directly to each other, but only through the United States as "head and heart of the system."[43]

However, a financial center ordinarily gains ascendancy, and retains it, by sustaining higher rates of growth and of profits within its own region that are registered elsewhere.[44] It can then attract an inflow of portfolio savings, and finance an outflow of direct investment as firms expand to absorb markets and secure sources of supply. The United States, by contrast, found it necessary in the summer of 1963 to stop a net <u>out</u>-flow portfolio investment by proposing an interest equalization tax on American purchases of foreign securities.[45]

---

[41] U.S. Congress, Joint Economic Committee, <u>A Description and Analysis of Certain European Capital Markets</u> (Economic Policies and Practices, Paper No. 3), 88th Contress, 2nd Session, 1964, pp.32,34.

[42] Kindleberger, <u>op. cit.</u>, p.203. See also Peter B. Kenen, "Towards an Atlantic Capital Market," <u>Lloyd's Bank Review</u> (March 1963).

[43] Stanley Hoffman, "Discord in Community: the North Atlantic Area as a Partial International System," in F.O. Wilcox and H.F. Haviland, eds., <u>The Atlantic Community: Progress and Prospects</u> (New York: 1963), p.23.

[44] Karl W. Deutsch found that a faster rate of economic growth in the "core area" was one of the essential conditions for political amalgamation. <u>Political Community in the North Atlantic Area</u>, p. 139.

The effect on foreign issues in New York was immediate, as Table 6. also shows. But it was offset by a rise in long-term bank lending abroad, from $150 million in the first half of 1963 to over $500 million in the second, and for the whole of 1964 exceeded the previous year's total by $400 million. The outflow of direct investment did not abate either, however. On the contrary, it rose from $1.9 billion in 1963 to $2.3 billion in 1964, a record half of it that year going to Europe.[46]

Concern about this "invasion" by American enterprise was expressed at the start of 1963 by the French Minister of Finance, who thought it undesirable "that essential sectors of the economy of the Common Market should become dependent on decisions from abroad."[47] But the balance of payments difficulties in which the outflow of capital placed the United States, made that challenge relatively easy to parry.[48] Apart from some tightening of French licensing procedures, and German proposals to register incoming direct investments, the primary defense against them has been a growing reluctance on the part of both countries to hold increasing dollar accumulations in their reserves.[49]

---

[45]With exceptions mainly for Canadian issues, this measure taxed American purchases of foreign shares at 15 percent, and of bonds from 2-3/4 to 15 percent. It was passed in August of 1964.

[46]U.S. Department of Commerce, Survey of Current Business (October 1964), p.10; and The Economist (February 13, 1965), p.669.

[47]Common Market (March 1963), p.51.

[48]Kindleberger's counterargument--that in fact a European demand for liquidity was financed by American direct investment--holds only if no inflationary pressures exist in Europe, which is not the case. See his Balance of Payments Deficits and the International Market for Liquidity (Princeton: Essays in International Finance, 1965), p.12.

[49]The Economist (January 23, 1965), p.361.

Table 7. suggests how vulnerable the United States has been to such pressure. Accordingly, in January of 1965 the French announced that they would begin converting some of their existing dollar claims into gold, and insist on gold settlements of all future surpluses and deficits.[50] The Germans had already allowed the gold portion of their reserves to rise from 51 to 59 percent in a little over a year, as a result of a rise in their gold holdings of $400 million, and a decline in their dollar claims of $1 billion.[51]

Table 7.

Changes in and Composition of International Reserves

	gold proportion 1961	changes in total reserves over previous year, in $ millions			
		1961	1962	1963	1964
United States		-606	-153	-377	-171
Germany	.51	131	-207	694	232
Belgium	.69	307	-60	187	252
France	.63	1,093	684	859	816
Netherlands	.81	95	-12	156	247
Italy	.61	548	19	-412	417
United Kingdom		-338	-10	-161	-831

Source: computed from International Monetary Fund, International Financial Statistics (Washington, D.C: August, 1965), p.15.

In response, the American authorities in mid-February extended the interest equalization tax to certain classes of loans, called on commercial banks to limit increases in their foreign lending to 5 percent, and asked industrial corporations to show an improvement of from 15 to 20 percent

[50] The Economist (January 9, 1965), p. 133.

[51] See Deutsche Bundesbank, Geschaeftsbericht fuer das Jahr 1964 (Frankfurt: 1965), pp.100-101; and The Economist (March 6, 1965), p.1045.

each in its own balance of international payments, over the current year.[52] Within a month, the reduced supply of dollars abroad had caused interest rates in the Euro-dollar market to rise by 3/4 of a percentage point.[53]

Further progress requires a Community framework

As the American challenge began to recede, three separate initiatives were launched to combine the resources of European capital markets independently, but without as yet resorting to a common European currency to do so. London was the first to take advantage of the U.S. interest equalization tax. A sharply increased volume of foreign bonds that might otherwise have been issued in New York, was floated in the Euro-dollar market instead. Quotations in London rose by a modest $20 million in 1963, but now jumped by another $365.5 million in the first 11 months of 1964.[54]

The relative efficiency of the London capital market no doubt made it the logical stand-in for New York. The spread between costs to the borrower and yield to the investor, as shwon in Table 8., may be taken as a rough measure of it.[55] But with the continued use of the dollar, the basic dependence of the market on the United States was also perpetuated.[56] Two risks in particular had to be taken into account: (1) The value of the market's

---

[52]Bank for International Settlements, Thirty-fifth Annual Report (Basle: 1965); and The Economist (February 27, 1965), p.887.

[53]The Economist (March 20, 1965), p.1296.

[54]The Economist (March 27, 1965), p. 1419.

[55]The data in the table are roughly comparable with those given for Germany, France, and Italy in Bank for International Settlements, Capital Markets (mimeographed, Basle, January 1964).

[56]One is tempted to think of the Euro-dollar market as perhaps another "special relationship".

means of payment was uniquely dependent on the exchange rate policy of the United States; and (2) the terms on which it was to be had could still be influenced by variations in American monetary policy, dictated less by European than by American needs.[57] The direct impact on Euro-dollar rates of the balance of payments measures of February 1965 showed how real this dependence was.

Table 8.

Rates on New Industrial Issues[1]

1962

annual interest equivalents

	Yield to Investor[2]	Burden on Borrower[3]	Spread
United States	4.45	4.6	0.15
Germany	6.10	7.0	0.90
Belgium	5.55	6.2	0.65
France	5.75	7.8	2.05
Netherlands	4.80	5.3	0.50
Italy	6.15	8.9	2.75
Switzerland	4.00	4.4	2.75
United Kingdom	6.45	6.7	0.25

1. entries based on a single "typical" issue.
2. rounded to nearest 0.05.
3. interest cost, plus taxation, underwriting, printing and publicity costs at time of issue, plus annual taxation and commission for the payment of interest.

Source: computed from The Times (London, April 16, 1963), p.16.

In order not to compromise an independent Europe for a wider capital market, therefore, an alternative to the dollar bond had to be devised as

[57] Cohen, op. cit., p.614.

a basis for it. One possibility was pioneered as early as 1961 by the Kredietbank of Brussels, in the form of bonds denominated in units of account.[58] The initial value of the unit was set equal to the gold value of the U.S. dollar.[59] But if the par value of 17 European "reference currencies" should change, two-thirds of them in the same direction, the unit's value will also change in the same direction and proportion as that currency among the two-thirds that moved the least.[60]

The value of the unit is thus not fixed in terms of the dollar or of gold, but in terms of whichever of the reference currencies turns out to be most stable among them. With respect to that currency, however, exchange risks for others continue very much as they have against the dollar. It is doubtful, therefore, that a widespread distribution of unit-of-account bonds can be achieved without some credible guarantee that exchange rates will remain fixed with reference to it. But any active trading across national boundaries will then again tend to equalize interest rates between participating markets, and thus reduce the power of national financial authorities over credit conditions in each.

---

[58] Unit of account have been used by the Bank for International Settlements, the European Payments Union, the European Monetary Agreement, the European Economic Community, and the European Investment Bank. The idea of using them for private as well as public transactions was first proposed in Robert Triffin, Europe and the Money Muddle (New Haven: 1957), p.291.

[59] The precise manner in which the value of the unit changes is newly defined for each issue. The specification given here is the standard one by Fernand Collin, The Formation of a European Capital Market and Other Lectures (Brussels: 1963).

[60] The reference currencies are those of the former European Payments Union: Austria, Belgium, Denmark, France, Germany, Great Britain, Greece, Iceland, Italy, Luxembourg, Netherlands, Norway, Portugal, Sweden, Switzerland, Ireland, and Turkey.

The ultimate responsibility for both exchange and interest rate policy will now be so diffused, however, that it is no longer clear to whom precisely the sovereignty of national monetary authorities would pass. The prospect of losing control was not for that reason any more cheerfully accepted by any of them. The total value of unit-of-account issued did not exceed $68 million, therefore, and all but $10 million of that was raised prior to 1964.[61]

The combined potential of the major European capital markets was of course considerably greater, as Table 9. shows. Still barring a common currency to destroy their compartmentalization, a last attempt was made by the Deutsche Bank of Frankfurt at least to coordinate access to them. Large loans were to be broken up into spearate tranches, each to be made out in the currency of a different country of issue, but with identical coupons, interest differentials between markets to be reflected in different terms of issue.[62] With control over capital issues itself a major instrument of credit control, however, it was not until the middle of 1965 that the first such European Parrallel Loan could be arranged, to raise the equivalent of $220 million for Italy in the six markets of the European Community.[63]

The Germans had meanwhile concentrated on expanding their own market for foreign issues, mainly to ameliorate balance of payments surpluses on

---

[61] See Jean O.M. van der Mensbrugghe, "Bond Issues in European Units of Account," International Monetary Fund Staff Papers (November 1964), p.453; and James C. Ingram, "Unit of Account Bonds: Their Meaning and Function," Moorgate and Wall Street (Autumn 1964), p.79.

[62] See Abs, op. cit., p.18; and David Williams, "The Development of Capital Markets in Europe," International Monetary Fund Staff Papers (March 1965), p.59.

[63] The tranches were: Italy ($160 million), France ($25.4 million), Germany ($25 million), Holland ($6.9 million), Belgium ($2 million), and Luxembourg ($0.6 million), The Economist (June 26, 1965, and July 3, 1965), pp. 1547-8 and 68 respectively.

Table 9.

Value of Outstanding Issues
billions of dollars

1962

	Total Business, Local and State Government	Central Government	Mortgages	Foreign
United States	669.9	110.5	250.5	6.8
Germany	23.6	1.2	20.3	.2
Belgium	9.0	6.0	----	1.0
France	30.7	3.2	8.7	----
Netherlands	12.7	4.2	3.3	----
Italy	31.6	4.1	----	----
Total E.E.C.	107.6	18.7	----	----
United Kingdom	73.9	46.4	15.0	2.3

Source: U.S. Congress, Joint Economic Committee, A Description and Analysis of Certain European Capital Markets (Economic Policies and Practices, Paper No. 3), 88th Congress, 2nd Session, 1964, p.8.

capital account. The U.S. interest equalization tax was in 1964 reinforced as a stimulus by two fiscal measures in Germany itself: (1) the proposed abolition of a 2½ percent tax on the nominal value of fixed interest issues, and (2) a proposed 25 percent withholding tax on foreign owned German bonds only, exempting foreign issues denominated in deutschmarks.[64] In response, foreign issues so denominated rose from $30 million in 1963 to $230 million in 1964, as shown in Table 5. above.

Frankfurt thereby moved into the major ranks as an international supplier of funds.[65] Nevertheless, before the mark can become the basis for

[64] Deutsche Bundesbank, "Foreign Loan Issues in the Federal Republic of Germany," Monthly Report (December 1964), pp.3-6; See also Bank for International Settlements, Thirty-fourth Annual Report, p.18.

[65] See The Times (New York, January 21, 1965), p.41.

a wider integration of capital markets, the problems of monetary sovereignty just described will obviously have to be resolved. Once that issue is settled, however, the physical location of the Community's capital market will probably lose much of its importance. The necessary set of institutions could easily be transferred from Frankfurt to Paris, as it was, for example, shifted from Frankfurt to Berlin under Bismarck.

But more neutral ground is likely to be preferred this time, in Luxembourg perhaps, which has already been designated the "financial center" of the Common Market by virtue of the recent relocation there of the European Investment Bank.[66]

POLICY

The need for a common currency as a condition for capital market integration in the European Community is becoming increasingly evident. With increasingly open markets, however, fixed rates of exchange can permanently be maintained only on the basis of effectively coordinated monetary policies. On both points, nevertheless, the Treaty of Rome is characteristically open-minded.

Exchange depreciation could restore for any member country the protection that tariff cuts are intended to reduce. Hence the sensitivity shown in the Treaty to exchange variations that "distort competitive conditions," and that may therefore trigger retaliatory action within the terms of the Treaty itself. Yet to prevent such disturbances, member countries are required to do no more than treat exchange rate policy as "a matter of common interest."[67] As with the freeing of capital movements, coordination of

---

[66] The Economist (March 10, 1965), p.980.

[67] Treaty of Rome, Article 107(1) and (2).

policy on monetary matters in general is required only "to the full extent necessary for the functioning of the Common Market."[68]

The implied reliance on the spill-over effect is once again associated with the obligation on the part of the Commission to consult the Monetary Committee on the nature and timing of its responses. How far, then, has a coordination of monetary policy progressed in the Community, and what specific counterpressures can be identified?

The Commission's objective is a monetary union

During the first stage of the integration process, from 1958 to 1962, little was in fact done. On the contrary, the revaluation of the German and Dutch currencies by five percent in March of 1961, though it precipitated massively disequilibrating movements of capital, was no more preceded by consultations among Community partners than with anyone else.[69] In its Action Program for the second stage from 1962 to 1966, therefore, the European Commission recommended setting up a Council of central bank governors to strengthen the institutional facilities for future coordination.[70]

The Commission's ultimate objectives were still more ambitious. The proposed Council was though of as the nucleus for a "federal type banking system" as, during the third stage from 1966 to 1970, it would "advance from the coordination to the centralization of decisions."[71] From the end

---

[68] Treaty of Rome, Article 105(2).

[69] European Economic Community, Fourth Report on the Activities of the Monetary Committee (Brussels, March 23, 1962), p.9.

[70] European Economic Community, Memorandum of the Commission on the Action Program of the Community for the Second Stage (Brussels, October 24, 1962), p.65.

[71] Ibid., p.67.

of the transition period at the latest, the Action Program foresaw that economic union would have to involve permanetly fixed rates of exchange --"the very essence of a monetary union"--as well.[72] Even the more modest initial proposals, however, were not formally submitted to the Council of Ministers until 1 July 1963.

To be sure, they then went somewhat beyond the establishment of a Committee of Central Bank Governors as suggested the year before.[73] In addition, a Budgetary Policy Committee was now to compare the national budgets of member states at an early stage in their preparation, to test them for mutual consistency. The responsibilities of the Monetary Committee itself were to be expanded to include consultation on decisions affecting the international monetary system, recourse by member states to the International Monetary Fund, and financial assistance to third countries. And members were formally to commit themselves to prior consultations on changes in the parity of their currencies.

A crisis was prerequisite to progress

The Council did not adopt these proposals until the threat of a serious inflationary crisis in the Community had dramatized the need for joint action to bring it under control.[74] The remarkably buoyant growth rates on which the Common Market was launched had, by 1962, virtually abosorbed labor reserves, as Table 10. indicates. As workers came to be in short supply throughout the Community, and increasingly free to move, appreciable wage

---

[72] Ibid., p.63.

[73] The text is reproduced in European Economic Community, Bulletin (Supplement, July, 1963), pp.33-40. See also "E.E.C. Commission Offers Monetary Proposals," European Community (July-August, 1963), pp.3-4.

[74] Murray Forsyth, "Towards a Common Economic Policy for the E.E.C.," Planning (July 27, 1964), p.7.

differentials between Common Market partners grew progressively harder to sustain.[75]

The tendencies toward factor price equalization in the Community were already identified in Table 3. above. Abrupt wage adjustments in Italy at the start and in Holland at the close of 1963, and a persistent upward drift in France so diminished savings margins, however, that investment ratios already lower than the German still led to severe inflationary strains.[76]

Table 10.

Trends in European Unemployment

	as percent of labor force	in thousands				
	1960	1960	1961	1962	1963	1964
Germany	0.9	237	161	142	174	156
Belgium	4.4	110	88	47	33	26
France	1.3	130	112	101	97	98
Netherlands	1.1	41	31	30	32	28
Italy	4.0	835	711	610	504	550

Sources: percent figures from Angus Maddison, Economic Growth in the West (New York: 1964), p.220. Otherwise from Organization for Economic Cooperation and Development, Main Economic Indicators (Paris, February, 1965), p.14.

In both France and Italy, the money supply had in any case been expanding at about twice the rate registered elsewhere in the Community, as investment was being pushed to the limits of voluntary saving.[77] Agressively restrictive policies in France, culminating in a major "stabiliza-

[75] Bank for International Settlements, Thirty-fourth Annual Report (Basle, June 8, 1964), p.7.

[76] Bank for International Settlements, op. cit., pp.10-14, and European Economic Community, Sixth Report on the Activities of the Monetary Committee (Brussels, April 15, 1964), pp.15-20.

[77] The annual percent rise in the money supply averaged 16 percent for (continued on the next page.)

tion program" on 12 September 1963, succeeded in minimizing the impact of rising wages on the balance of payments, as Table 11. shows. In Italy,

Table 11.

Investment and the Balance of Payments

	gross investment ratio	current account suplus in millions of dollars				
	1964	1960	1961	1962	1963	1964
United States	17.9	3097	4928	4411	5080	7721
Germany	27.7	1722	1593	419	1082	977
Belgium	19.9	160	90	120	-34	46
France	21.4	688	974	903	497	111
Netherlands	27.0	372	219	189	81	-164
Italy	22.9	354	552	330	-665	736
United Kingdom	18.3	-450	263	591	650	-521

Sources: for investment ratios, Bank for International Settlements, Thirty-fifth Annual Report (Basle: 1965), p.39. Otherwise, European Monetary Agreement, Annual Report 1963 (Paris: 1964), and Annual Report 1964 (Paris: 1965).

on the other hand, a much more fluid political situation, toegether with fairly high initial exchange reserves and somewhat easier employment conditions, induced the authorities to overlook accelerating capital outflows and rising imports long enough for a major balance of payments crisis to develop in 1963.[78]

The effect on Germany was a sharp recovery of its export surplus, the

[77]Italy and France from 1960 through 1963, but varied from 7 to 9 percent elsewhere in the Community. Computed from International Monetary Fund, International Financial Statistics (May 1965).

[78]Rising imports especially of meat and motor-cars reflected the effect on consumer tastes of a large structural shift of labor from agriculture to the cities; the capital outflow increasingly took the form of currency exports. See European Economic Community, op. cit., p.17, and Bank for International Settlements, op. cit., p. 10.

bulk of it on Community account. The resulting strain on German resources was sufficiently strong for a committee of experts to recommend flexible exchange rates to protect internal equilibrium, as the Italians might have done to protect external balance.[79] But inasmuch as the inflationary pressures at the periphery were in large measure the direct consequence of the customs union, a relative depreciation of the Italian currency would have to become recurrent, unless it was part of complete withdrawal from the Common Market.

To stay in, without upsetting the Community's monetary equilibrium, the Italians could not in the end escape the necessity of adjusting their investment ratio to the new distribution of income. They therefore opted, on 25 February 1964, for deflation.[80]

The European Commission had for some time urged this course.[81] It now took advantage of the emerging policy consensus to press for a coordinated stabilization program at Community level. In response, the Council of Ministers on 13 April 1964 adopted a Recommendation specifying the priority of price stability over all other economic policy objectives, setting a 5 percent ceiling on the permissible increase in government expenditures, and urging a spectrum of measures to restrict credit and restrain wages.[82] At the same time the Council issued a series of Decisions implementing the

---

[79] Press report, Brussels, January 14, 1965; and Opera Mudni Europe (January 21, 1965), p.7

[80] Bank for International Settlements, op. cit., pp.10-12; European Economic Community, op. cit., p.25.

[81] With particular urgency in the annual report of the Commission presented by Robert Marjolin to the European Parliament on January 21, 1964. See European Economic Community, Bulletin (March 1964), for the full text.

[82] Journal Officiel des Communautes Europeennes (April 22, 1964), pp. 1029-1064. See also European Economic Community, Seventh Report on the Activities of the Monetary Committee (Brussels, February 12, 1965), p.7.

Commission's institutional proposals, and a Declaration that there would in future be prior consultations on changes in currency parities.

Stabilization alone is not enough

For the present, exchange rates held, though at a cost. The Italian balance of payments improved, but the part played by foreign investors buying up portions of Italian companies in distress was large enough to be painful.[83] The effect of retrenchment on growth rates was in any case marked, as Table 12. demonstrates. Perhpas the sacrifice of growth for stability at the periphery could "only be welcomed from the standpoint of the Community," as the Commission thought.[84] Yet until such interests as were sacrificed nationally gained some certainty of finding adequate consideration at Community level, the possibility of opting out of the Community, and of reasserting monetary independence, certainly had to remain open.[85]

The Treaty itself does not ensure that regional balance in the Community's development is maintained, though to "reduce" differences between regions and to "mitigate" the backwardness of the less favored areas is one of its stated aims.[86] Without any more of a clear directive, the Commission at first contented itself with organizing conferences and setting up working parties to study the matter.[87] Its Action Program next called for

---

[83] The Economist (February 6, 1965), p.590. The companies involved included Montecatini and Olivetti.

[84] European Economic Community, The Economic Situation in the Community (December 1964), p.38.

[85] Deutsch stipulates "mutual responsiveness" as one of the most essential conditions for successful integration. See Political Community and the North Atlantic Area, p.130.

[86] Treaty of Rome (Preamble); and Political and Economic Planning, Regional Development in the European Economic Community (London: 1962), p.66.

[87] European Economic Community, Sixth General Report on the Activities of the Community (Brussels, June 1, 1963), pp.120-122.

a medium-term economic program into which regional and other policies might be fitted. But it was rebuffed by the German Chancellor in the name of free market principles.[88]

The Commission nevertheless succeeded in having a medium-term economic policy committee authorized by the Council of Ministers, along with its monetary innovations, in April of 1964.[89] The unsettling impact of the stabilization effort gave a sudden urgency to its work on a development program for 1966-1970, in terms of which short-run sacrifices might be vindicated.[90] In particular, the development of an integrated industrial complex in southern Italy, on which planning had progressed independently, now achieved a special priority.[91]

At the same time the Commission did not hesitate to formulate proposals for a pooling of external reserves as the next step towards a monetary union.[92] Without strict rules on credit policy, such a pool could easily be abused of course, and the Germans therefore favored expanding the Council of Central Bank Governors into a effective "open market committee" first.[93] The closer the Community moves to formal monetary union, however, the more hesistant progress is likely to become. For "the power of decision in monetary matters is one of the traditional attributes of national sovereignty," as the Commission is well aware.[94]

---

[88] Forsyth, op. cit., p.217.

[89] Ibid., p. 220, and European Community (September 1963), p.3.

[90] Robert Marjolin reporting to the European Parliament on September 23, 1964. See European Economic Community, Bulletin (November 1964), p.13.

[91] The Economist (May 8, 1965), p.670. See also European Community (April 1965), p.6.

[92] Robert Marjolin reporting to the European Parliament on March 23, 1965. See European Community (April 1965), p.6.

[93] The Economist (January 23, 1965), p.365.

[94] Continued on next page.

CONCLUSION

"So much of barbarism," said John Stuart Mill, "still remains in the transactions of most civilized nations, that almost all independent countries choose to assert their nationality by having, to their own inconvenience and that of their neighbors, a peculiar currency of their own."[95] The countries of the European Economic Community seem well on the way to eliminating that inconvenience among themselves. Still, no inevitability should be ascribed to the process. As was stated at the outset, precisely when the creation of a common currency comes to threaten the foundations of sovereignty, the impulse to withdraw may well become irresisitible.

The political significance of money derives from the fact that it can not exist without a set of individual producers accepting a collective identity. For if each producer issued his own currency, in terms of which he then priced his product, the distinction between a currency depreciation and an individual price fall would disappear. Money itself would then in fact have given way to barter.[96] But once several producers have joined in a single currency arrangement, they may, by a depreciation of the exchange rate, respond collectively to a fall in the external demand for any one of their products.

The option of such a collective response to economic adversity would be destroyed within the Community by a common currency. Producers would

---

[94] Robert Marjolin, "Monetary and Financial Cooperation in the E.E.C.," European Economic Community, Bulletin (November 1963), p.8.

[95] John Stuart Mill, Principles of Political Economy, Vol. II. (New York: 1894), p.176.

[96] See Robert A. Mundell, "A Theory of Optimum Currency Areas," American Economic Review (September 1961), p.662.

henceforth have to meet in the Common Market as individuals only, not as nationalities. One may still argue that "even if they form a single economic unity, the six nations are not obliged to have one identical foreign policy," for example.[97] Yet no individual government is likely to go very far on its own, once it has lost as much autonomy over its resource base as it would have in a monetary union.

If in fact a single national identity is not intended, then the customs union must also be called in question. For by itself, as we have seen, it creates serious tensions that cannot be resolved except by moving forward in the direction of political union--or else by giving up the enterprise altogether. That is the meaning here proposed for the "spill-over" effect.

[97] Raymond Aron, "Old Nations, New Europe," Daedalus (Winter 1964), p.55.