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The Werner Report revisited

The Werner Report on the realisation by stages of economic and monetary union was drawn up against the background of the end of the transitional period leading to the completion of the customs union and the definition of the Common Agricultural Policy. The Hanover Council has asked that renewed impetus should be given to the objective of economic and monetary union in the light of the adoption of the Single European Act and the fact that the process of completion of the internal market programme has now reached a point at which it is irreversible.

This discussion paper first outlines the main features of the Werner Report and its legislative follow-up. It then gives an assessment of the Report itself and its implementation. Finally it discusses some major developments during the post-Report period.

I. Main features of the Report

The Werner Report gave a comprehensive definition of the final objective, which it said should be achieved by stages. A detailed description of the measures needed for implementing the first stage was, however, not matched by an examination of the process by which one stage would lead to another and to the final objective. The second stage was essentially to have been a reinforced first stage. The Report also paid relatively little attention to institutional matters.

1. The final objective

Economic and monetary union, the Report said, would make it possible to "realise an area in which goods and services, people and capital will circulate freely and without competitive distortions, without thereby giving rise to structural or regional disequilibrium". Equilibrium within this area would be achieved, as in an individual national economy, by the mobility of factors of production and financial transfers by public and private sectors. Hence only the balance of payments of the Community as a whole would be of importance.

Monetary union would imply "the total and irreversible convertibility of currencies, the elimination of margins of fluctuation in exchange rates, the irrevocable fixing of parity rates and the complete liberation of movements of capital".

The Report considered that many elements of economic policy-making in this union would have to be centralised or transferred to the Community. "The creation of liquidity throughout the area and monetary and credit policy will be centralised; monetary policy in relation to the outside world will be within the jurisdiction of the Community; and policies as regards capital markets would have to be unified." Also, "the essential features of the whole of the public budgets, and in particular variations in their volume, the size of balances and the methods of financing or utilising them, will be decided at the Community level. Regional and structural policies will no longer be exclusively within the jurisdiction of the member countries; and a systematic and continuous consultation between the social partners will be ensured at the Community level".

The Report recognised that the above would require "the creation or the transformation of a certain number of Community organs to which powers until then exercised by the national authorities will have to be transferred". It did not, however, give detailed consideration to the institutional structure that would be necessary, but it considered that the following two Community organs would be "indispensable to the control of economic and monetary policy inside the unions":

(i) a Centre of decision for economic policy, which would in itself exercise a decisive influence over Community economic policy, and especially national budgetary policies. It would also have responsibility for changes in the parity of the sole currency or the whole of the national currencies. The Centre would have to be politically responsible to a European Parliament;

(ii) a Community system for the central banks, which could be based on the structure for the Federal Reserve. It would conduct the principal elements of internal monetary policy and be responsible for intervention on the foreign exchange markets.

2. The first and second stages

The primary aim of the first and second stages was to reinforce the co-ordination of economic policies so as to make it possible to decide on guidelines in common. The intention was that constraint on national policy-making should be applied progressively. This was to be achieved by a strong interaction between decision-making at Community and national levels. National decisions were progressively to be made in the light of Community guidelines; and as well as there being a system for prior consultations for budgetary and monetary policy, performances would be closely monitored. A system of indicators would detect the emergence of potentially dangerous situations.

The co-ordination of general economic policy-making was to be principally the responsibility of the Council, which would fix medium-term objectives and annual programmes on the basis of a detailed procedure which was designed to lead to permanent surveillance of the economic situation.

The Committee of Governors of the Central Banks was to play an increasingly important role in both internal and external monetary policy-making. So as to define the general guidelines of monetary and credit policy, the Committee was to prepare the regular Council meetings which the Governors were to attend.

The Governors would also manage the proposed system for Community exchange rate relations, which would progressively lead to a narrowing of the fluctuation bands.

"Progress in the convergence of economic and monetary policies should be such in the course of the second stage that Member States no longer have to resort on an autonomous basis to the instrument of parity adjustment."

The creation of a "European Fund for monetary co-operation" would be necessary in the second stage, but it could also be part of the first stage. The Fund would take over the short and medium-term support mechanisms and would progressively manage Community reserves. In the final stage it would be integrated into the system of Community central banks.

II. Follow-up to the Report

1. The Werner Report considered that the first stage could last three years and begin at the start of 1971. In March that year the Council adopted a Decision on the strengthening of co-operation between central banks and a Resolution on the attainment of economic and monetary union by stages. That Resolution accepted the definition of the final objective that had been given in the Report and the need for a broadly-based package of measures to strengthen the co-ordination of economic policy-making.

Over the following three years, a number of important measures were taken to implement the first two stages:

- 1972: the "snake" was created, and the Council Directive on regulating international capital flows and neutralising their undesirable effects on domestic liquidity was adopted;
- 1973: the European Monetary Co-operation Fund (EMCF) was set up;
- 1974: the Council Decision on the attainment of a high degree of convergence of economic policies and the Directive on stability, growth and full employment were adopted.

2. However, the legislative implementation did not fully correspond to the letter or the spirit of the Report.

Firstly, little consideration was given to policies other than monetary or budgetary policies: the initial actions were concerned only with limiting exchange rate fluctuations, and the 1974 Decision on convergence concentrated largely on procedures for the co-ordination of budgetary policies.

Secondly, interaction between the Community and the member states in policy-making was not really put into practice. The important prior consultation was lacking, and there was no internal pressure on member states to follow the guidelines given at the Community level. Procedures were defined for ex-post monitoring and giving recommendations, but they were rarely used.

Thirdly, the Committee of Governors was not given extended powers to play an increasingly important role in the co-ordination of monetary and credit policy as had been called for in the Report. Procedures were not put in place, had been recommended, for obligatory prior consultations and to allow the Committee to lay down general guidelines for monetary and credit policy for the Community. Moreover, whereas the Report had said that monetary policies should be determined "having regard" for the guidelines for general economic policy, the 1971 Resolution said that monetary policy should be co-ordinated while observing these guidelines. Furthermore the EMCF was put under the "observing" control of the Council, whereas the Report had said that it should be under the control of the central bank Governors.

III. An assessment

The Werner Report had concluded that economic and monetary union could be achieved within a decade, provided that the political will existed to realise that objective. However, by the mid-1970s the momentum had been lost and the Werner Report was no longer a driving force in Community developments. This can be attributed to the change in the international environment, but it may be asked whether it was not also due to possible intrinsic weaknesses in the Report. Among these the following could be of special relevance: insufficient constraints on national policies, institutional ambiguities, inappropriate policy conception and lack of internal momentum.

1. Change in the international environment

The collapse of the Bretton Woods system together with the first oil price shock significantly altered the economic environment in which the Report had been expected to be implemented. However, these unforeseen changes did not pose insurmountable problems of a technical nature. Adjustments to the Report's technical framework would have been possible and, indeed, were to some extent attempted in the context of the "snake". Rather, the basis for co-ordinating economic policy was greatly undermined by disagreements about the appropriate policy response to the oil shock and by expectations that more flexible exchange rates would enlarge the scope for autonomous domestic economic management.

2. Insufficient constraints on national policies

While the Report advocated obligatory prior consultation procedures initially involving existing Community bodies - the impetus for a process of convergence and progressive integration rested basically on voluntary agreement on broad Community objectives which were to be achieved through national policies carried on in accordance with guidelines. These guidelines had the character of recommendations and there was no provision to ensure their observance. Such an approach could work only as long as there was a sufficiently strong policy consensus and willingness to co-operate. However, once that consensus began to weaken more binding constraints on national policy would have become necessary; in other words, the Report lacked safeguards against (temporary) lapses in policy consensus.

3. Institutional ambiguities

While the Report concentrated on the mechanics of how and when decisions should be made, it left it somewhat unclear who should make the decisions and how responsibilities were to be distributed. For instance, although the Committee of Governors was supposed to be given extended powers, the scope of these powers relative to those of the Council was left ambiguous.

4. Inappropriate policy conception

The procedures for policy co-ordination detailed in the Report implied a very high degree of confidence in the ability of policy instruments to affect policy goals in a known and predictable way. This over-optimistic view of the efficacy of economic management gave rise to a rather mechanistic end relatively rigid approach to policy co-ordination (especially in the budgetary field) which left less room for discretionary and flexible policy responses than was needed in the face of changing economic circumstances.

5. A lack of internal momentum

The first stages were self-contained and lacked a dynamic element. They formed a complete process rather than a framework within which there could be growing pressures for policy co-ordination. This led to both a lack of internal momentum within a given stage and insufficient impetus to move from stage to stage towards the final objective. The report did not envisage an interactive process in which the implementation of certain steps would trigger market reactions that in turn would necessitate further steps towards economic and monetary union. Rather, the Report's method tended more towards stressing the need for parallel progress.

IV. The post-Werner Report period

From the mid-1970s onwards developments in the economic environment, the policy consensus and the Community itself increasingly changed the background against which progress towards economic and monetary union could be considered.

1. The economic environment

Two features can be singled out as being of primary importance. Firstly, inflation. The Werner Report was written against the background of a relatively long period of price stability. By contrast, the following decade saw the average inflation rate in the Community rise well above 10%. In the course of the 1980s, the average inflation rate in the Community has again been brought down to levels not seen since the 1960s. The experience of high inflation and of the severity of the measures necessary to curb inflation once it has taken hold in an economic system has emphasised the need for monetary arrangements that promote and preserve stability.

Secondly, international monetary arrangements have also moved through a complete cycle. The Werner Report was written as the dollar-denominated Bretton Woods system was collapsing. There then followed a period of floating exchange rates in which policy co-ordination was minimal. More recently there has been an evolution towards a more managed and multi-polar system. Policy co-ordination has been strengthened through multilateral surveillance procedures and currency arrangements have been developed.

2. Policy consensus

Towards the end of the 1960s there was a remarkable consensus on policy-making. The evidence seemed to strongly confirm the effectiveness of medium-term planing and fine-tuning. In the 1970s experience with stagflation destroyed this consensus. Now a new consensus has developed in which attention has shifted towards medium-term financial stability, the supply side of the economy and structural policies. Part of the legacy of the earlier consensus is, however, large budget deficits and a high level of government debt. When the Werner Report was drafted, budgets in the Community were in approximate balance. Deficits subsequently peaked at over 5% of GDP and are still above 4%. Government debt at the beginning of the 1970s averaged less than 40% of GDP, whereas it now averages over 70%.

3. The Community

(a) Significant non-monetary developments

Although the Community entered a difficult phase as it absorbed new members within an unchanged framework and in an unfavourable economic environment, a number of steps were taken. Among these, as well as enlargement itself, were the following:

- in 1974 the European Council was created to take the place of the earlier summit meetings held at irregular intervals; it became the driving force of the subsequent development of the Community;
- in 1975 the first European Regional Development Fund was set up, representing the beginning of a growing redistributive role for the Community budget;
- in 1977 the Sixth VAT Directive establishing a uniform basis for collection was adopted, marking a major step in the process of tax harmonisation;

- in 1979 the first direct elections to the European Parliament were held, broadening the democratic basis of the European structure.

(b) Monetary developments

The European Monetary System was created in 1979, with the primary objective of establishing a zone of monetary stability, involving both low inflation and stable exchange rates. The exchange rate constraint has acted as a focal point for improved policy co-ordination, and the EMS has provided a framework for enhancing multilateral surveillance within the Community. Participants have gradually opted for a strong currency policy stance, so putting the greatest emphasis on domestic adjustment measures. The system has evolved in response to changes in the economic and financial environment, especially improved convergence and increased capital mobility. Most recently, the Basle/Nyborg Agreement of September 1987 made some important modifications to the mechanisms of the system to secure a more balanced implementation of the exchange rate commitment by all participants. The procedures for surveillance were also strengthened.

The use of the ECU within the system has been limited. By contrast, the non-official use of the ECU, especially as a denominator of financial transactions, has increased considerably. International banking business in ECU has expanded markedly and a significant share of international bond issues is now denominated in ECUs. The non-financial use of the ECU, however, has remained limited although some increase appears to have taken place recently.

(c) New Community impetus in the 1980s

The internal market. In 1985 the programme for completing the internal market was proposed by the Commission and adopted by the European Council. It aims, as already stated in the Werner Report, at achieving full freedom of circulation of goods, services, people and capital by 1992, and to this end calls specifically for the removal of all physical, technical and fiscal frontiers.

In November 1987 proposals for the creation of a European financial area, including the full liberalisation of capital movements, were tabled. These were adopted by the ECOFIN Council of June 1988 and will be implemented by most members states by 1990. The early implementation of full capital mobility will entail further developments in other areas. For example, since it will increase the potential for exchange rate instability, it will be necessary to further reinforce co-operation within the EMS. Also, as the Werner Report recognised, measures will have to be taken so that differences between tax regimes do not lead to distortions or increased tax evasion.

The Single European Act is the first significant modification to the Treaty of Rome. Its enactment was possible because the internal market programme laid out in the White Paper of 1988 had given the Community a new and concrete objective, together with a more streamlined method of implementation based on mutual recognition rather than full harmonisation and a fixed timetable. The Single European Act makes changes that are vital to ensuring that the internal market programme can be completed within the specified time scale. In particular it greatly expands the scope of majority voting and lays the basis for an improved institutional balance within the Community with a strengthened role for the European Parliament. The Single European Act not only deals with the internal market but also sets objectives and provides for action in the following related areas: social policy, economic and social cohesion, research and technological development and the monetary capacity of the Community.

Accompanying policies. The Brussels European Council of February 1988 agreed on a package of measures which, as well as putting the Community budget on a solid basis and reinforcing the reform of the Common Agricultural Policy, will lead to a doubling in real terms of the Structural funds. By 1992 Portugal, Greece and Ireland will be receiving inflows of grants and loans from the Community amounting to between 3 1/2 and 6 1/2% of their GDP (and hence 15 to 30% of their gross investments). Transfers to Spain and Italy could amount to something of the order of 1% of GDP.

V. Conclusions

The link between the free movement of goods, services and capital and the need to create an economic and monetary union was the point of departure of the Werner Report; and the mandate from the Hanover Council also comes at a time when significant progress is being made towards completing the internal market. The two processes are self-reinforcing, and the full potential of the single market will only be realised with satisfactory monetary arrangements.

Since the Werner Report was written many of its recommendations have been implemented and there have been significant developments going beyond those that the Report considered to be necessary for the first steps towards economic and monetary union. That ultimate goal, however, still remains unachieved. This is partly because of unfavourable external circumstances, but also because of intrinsic weaknesses in the approach and inadequate implementation. A better understanding of these shortcomings can only increase the chances of future success.

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