COMMITTEE FOR THE STUDY OF ECONOMIC AND MONETARY UNION

2nd December 1988

Please find attached a copy of the skeleton of the Report which, in accordance with the Chairman's letter telefaxed to you on Friday, 2nd December 1988, will be the subject of the Committee's discussions at the forthcoming meeting in Basle.

COMMITTEE FOR THE STUDY OF ECONOMIC AND MONETARY UNION

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Note to the members of the Committee

The following "skeleton" of the final report has been drafted with a view to making available to the Committee, for its further discussions, a document covering concisely, but fairly comprehensively, the most relevant subjects that could be dealt with in the final report. At this stage only a few of the elements to be included in Part I have been sketched out. As regards Parts II and III, which will contain the substantive proposals of the Committee, the draft is largely tentative and hypothetical. Given that the Committee's deliberations are still at a relatively early stage, written and oral contributions offered by members so far have not been sufficient to cover all aspects of a final report. The gaps have been filled with text formulated in a descriptive manner and containing ideas that could contribute to a complete and internally consistent final document. Where this proved particularly difficult and uncertainties are greatest, square brackets have been used and questions have been explicitly asked.

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COMMITTEE FOR THE STUDY OF
ECONOMIC AND MONETARY UNION

CSEMU/5/88
25th November 1988

Skeleton of the Report

Outline

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Part II The present state of economic and monetary integration in the Community

(to be drafted)

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1. Principles governing a step-by-step approach
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Skeleton of Report

25th November 1988

Draft

I. The final stage of economic and monetary union

1. Introduction

The establishment of an economic and monetary union will represent the final stage in the progressive process of economic integration in Europe. With the completion of this ultimate objective, the Community will form an area in which all residents can engage freely and without impediment in any kind of economic activity, subject only to commonly applied or mutually recognised rules and regulations and economic policies geared towards price stability, balanced growth and converging standards of living, high employment and external equilibrium. These policies will - to the extent necessary for an efficient economic management - be formulated and carried out at the Community level. The functional and institutional arrangements of the economic and monetary union will have been implemented in accordance with a new Treaty.

Economic and monetary union thus means that the Community is transformed from a set of interdependent national economies into a single economy, with the same basic features that circumscribe the existing national economies: a single currency area, a single market and an institutional framework for economic policy management. At the same time, however, an economic and monetary union in Europe will differ fundamentally from existing economies in one important respect: made up of independent, historically grown nations with different levels of economic development and differing traditions, social customs and languages, the Community will remain much more heterogeneous than any of its constituent economies. It is precisely this difference that makes it impossible simply to model Europe's economic and monetary union on one of the existing economies and makes it necessary to develop an innovative and unique solution.

In its search for such a solution and for ways and means of gradually implementing it, the Committee is taking the view that a step-by-step approach to the final objective can be established only if

there is a clear understanding of the meaning of economic and monetary union, its implications for the working of the economy and economic decision-making and the principal elements that have to be in place for its successful and durable functioning. Economic union and monetary union form two integral parts of a single whole and it is only for reasons of expositional clarity that in the following sections a distinction is drawn between them.

2. The principal features of monetary union

A monetary union describes a single currency area, i.e. an area in which one money serves as a means of payment, unit of account and store of value for all residents of that area. This definition implies that the process of monetary integration in the Community will be concluded when a new single currency - ~~the ECU~~ - has replaced the existing national currencies and when the new currency is managed with due regard for domestic price stability by a European system of central banks. Only at this stage will it be possible to say with certainty that the Community will have developed its own monetary identity and that the benefits of monetary integration will materialise fully.

The transition from a system of co-existing national currencies to a single currency represents the final act of setting up a monetary union in Europe. However, this ultimate step can be taken only after the ground has been carefully prepared for a smooth changeover to the new currency. This requires two types of arrangements. Firstly, it requires the implementation of a set of macro-economic and micro-economic measures designed to reduce significantly market perceptions of differences between national currencies. Only when, in the eyes of market participants, all currencies are of roughly equal quality and standing will they become close substitutes for each other, thus approximating the conditions that are representative of a single currency area. In practice this situation will be attained when interest rates on comparable financial instruments have become virtually identical, irrespective of the national currency in which the instrument is denominated, and when differences between prices of tradable goods have more or less disappeared. Secondly, it requires the introduction of the currency which will eventually replace national currencies. The principal reason for this measure is to help market

participants to familiarise themselves with the new currency, promote its acceptance and use and thereby facilitate the difficult organisational task of transition to a single Community currency.

The final stage on the way to monetary union thus does not consist of one single step, but rather describes a dynamic process leading ultimately to the installation of a single currency in the Community. This process will be driven by the interaction of official action and market development. The essential macro-economic measures laying the foundations of a single currency area encompass, as already mentioned in the 1970 Werner Report:

- the assurance of total and irreversible convertibility of currencies;
- the elimination of margins of fluctuation and the irrevocable locking of exchange rates; and
- the complete liberalisation of capital transactions and full integration of banking and other financial markets.

Two of these requirements - the convertibility of Community currencies and the creation of a free and fully integrated financial market - have already been met or will be with the completion of the internal market programme. But the most decisive measure - the irrevocable locking of exchange rates - can only be implemented when the appropriate conditions for entering the final stage have been realised.

However, the three macro-economic requirements emphasised in the Werner Report, while indispensable elements of a single currency area, would not necessarily lead by themselves to the degree of currency substitutability that would allow an easy move to a single currency. The continuing existence of national currencies - even if only for purely symbolic reasons - could cast doubt on the member countries' commitment to unchangeable exchange rate parities and thus engender divergent assessments of individual currencies in the market-place. Furthermore, even if fluctuation margins were abolished, the exchange of one currency for another would entail costs for commercial banks and could give rise to bid/offer spreads. Both developments would produce interest rate differentials between individual currencies, indicating that they were not yet considered to be perfect substitutes. For this reason complementary

measures of a micro-economic nature are needed. Such measures should include:

- the recognition of the legal tender status of each national currency in each of the member countries of the Community;
- provisions to ensure that different currencies are exchanged in the market-place in the same way as different bank notes of a national currency can be exchanged;
- and, preferably, an easy conversion system, i.e. a rebasing of currencies resulting in a set of exchange rates that allows a quick and convenient comparison of prices expressed in different currencies.

However, while such micro-economic measures will enhance the substitutability between currencies, a situation in which all currencies have lost their particular identity can only be reached over time and in an evolutionary process. The pace of this process will depend critically on the extent to which the irrevocable locking of exchange rates can gain credibility in the market-place. But even when perfect substitutability between national currencies has been attained, the final step of introducing a single currency represents a complicated exercise involving a change in deeply ingrained habits of Community residents and a major organisational challenge. The replacement of national currencies can only be carried out over a time span comprising several years.

If the ECU is ultimately to assume the role of the single Community currency, not only must it at the time of transition embody all features and functions of a currency, but it must also have attained widespread popularity and proved its usefulness in commercial and financial transactions. Only if the ECU has penetrated markets will it be an acceptable replacement for national currencies. Two approaches to promoting the ECU and preparing it for its future role as the single Community currency are conceivable.

The first course would build on existing arrangements. In particular, it would leave unchanged the basic provisions governing the creation and use of ECUs among national central banks (although the system of swaps could be replaced by an arrangement for a permanent exchange of official reserves for ECUs). This would rule out the establishment of a

link between officially created ECUs and ECUs used in the market as a denomination for financial contracts, issues of securities, bank deposits, and consolidated accounts of multinational corporations; nor would there be any scope for an autonomous process of money creation involving the ECU or any need for setting up a "central bank for the ECU". In accordance with its present basket definition, the ECU would remain a weighted average of Community currencies and its role, outside the realm of national central banks, would be confined to that of a convenient "denomination". However, in order to permit an increasing use of the ECU as a numeraire, all regulatory impediments that may now hamper its more widespread utilisation as a denomination should be removed. To some extent this would permit Community residents gradually to get acquainted with the name and the approximate value of the future common currency and leave it to the discretion of the market to decide whether to use the ECU in setting prices, keeping corporate accounts and contracting any kind of pecuniary obligation.

A second option would be to alter the present arrangements and to introduce the ECU as an additional currency, which would no longer represent a weighted average of Community currencies, but would be independently defined, have fixed but adjustable exchange rates vis-à-vis national currencies and be managed under the responsibility of the European system of central banks. This would imply an autonomous process of ECU money creation which would have to be co-ordinated closely with the creation of money by national banks. This route could strengthen the role of the ECU markedly in the Community but it could also complicate the conduct of monetary policy.

[A more detailed discussion of the preparatory measures for a move to a single currency requires guidance on: what should be the single currency? What role can the ECU play? Is it a suitable precursor of the Community's currency? In what form, i.e. as a standard basket or as an independently defined ECU? When should the new currency be introduced publicly as the Community's future currency? Should at the time of pronouncement the future currency be an additional currency existing alongside national currencies? Should it enjoy from the outset a superior status, for instance in terms of legal tender provisions or as "reserve money" for national central banks?]

The process of monetary integration will have far-reaching consequences for the conduct of monetary policy in the Community and profoundly affect the functioning and performance of its economy. Many of these developments will in practice come about gradually in the wake of closer policy co-ordination and market responses to changing circumstances, but the most decisive change will occur when exchange rates are irrevocably locked and the Community enters the final stage on the way to monetary union.

As far as monetary policy is concerned, the adoption of fixed exchange rates in an environment of free and fully integrated capital and money markets means that there will no longer be any scope for independent national monetary policies. Any attempt to pursue a national monetary policy would be incompatible with the maintenance of fixed parities and thus destroy the foundations of the monetary union. The final objective can therefore be realised only if the Community countries consent to having one monetary policy and, by implication, one exchange rate policy vis-à-vis non-Community currencies. This presupposes that all member countries agree on the objectives of monetary policy and, as discussed in Section 4, that appropriate institutional arrangements have been made which allow the pursuit of a single monetary policy for the Community as a whole. In practice, however, the incision will not be so deep but will rather mark the completion of a progressively intensified co-ordination of national monetary policies, which had in many respects already foreshadowed the move to a single monetary policy in the Community. Even prior to the decision to fix exchange rates permanently, the liberalisation of capital movements and financial market integration will have created a situation in which the conduct of monetary policy at the national level has been rendered extremely difficult. Once every banking institution in the Community is free to accept deposits from and grant loans to any customer in the Community and in any of the national currencies, the large degree of territorial coincidence between the national central banks' area of jurisdiction, the area in which their currency is used and the area in which "their" banking system operates, will be lost and it will only be possible for monetary policies to be effectively managed in common if instruments of policy are harmonised and if broadly compatible objectives are pursued.

As far as the functioning and the performance of the economy of the Community is concerned, the move to monetary union will entail advantages but also drawbacks with important implications for policies in non-monetary areas. To a significant extent these consequences originate directly from the locking of exchange rates, but not all the benefits will be realised before a full monetary union is established. This applies, in particular, to the most fundamental gain from monetary union - the lowering of costs of transactions between residents of different countries of the Community and the stimulatory impact this will have on trade, the allocation of resources and economic growth - which can only materialise fully when national currencies have given way to a single Community currency. Other advantages, however, will be felt earlier. For instance, once parities are frozen, movements of exchange rates unwarranted by fundamental factors can no longer be a source of macro-economic disturbances and competitive distortions. Moreover, the locking of exchange rates in combination with an unrestricted single market also means that trade between residents of different countries of the Community represents a domestic (and not an external) transaction - with the result that the Community as a whole will be much less open and less susceptible to external shocks than any of its individual member countries. Finally, if it is firmly believed that exchange rates are permanently fixed, market participants in all countries are likely to behave more conformably and thereby contribute to the evolution of a more homogeneous economic structure in the Community.

The most serious drawback of a monetary union is that the exchange rate can no longer serve as an instrument for adjusting economic imbalances among member countries, shifting the need for adjustment to other market mechanisms and, as discussed in the next section, necessitating effective safeguards in non-monetary policy areas. Moreover, with exchange rates locked and national currencies being perfect substitutes, the concept of national balances of payments of member countries no longer applies, with the result that two important sensitive indicators of disequilibria between countries - the exchange rate and the balance of payments - are no longer available as guideposts for policy-making.

In summary, the realisation of a monetary union means that the Community has adopted one currency. This final objective can only be

attained if measures are taken already at a time when national currencies are in existence that generate the conditions representative of a single currency area. Such measures comprise the locking of exchange rate parities, the elimination of fluctuation margins and full integration of financial markets, but also micro-economic measures which permit all currencies to fulfil the traditional monetary functions in all member countries of the Community. Once these steps have been taken, independent national monetary policies must be replaced by the formulation and execution of one monetary policy for the Community in the context of a European system of central banks. This system will also be in charge of managing the new currency of the Community which should be introduced [before or at the time when] the European system of central banks has assumed full responsibility for the conduct of the Community's monetary policy.

3. The principal features of economic union

An economic union traditionally describes a unified and unrestricted market. If, however, the creation of this market across national frontiers is accompanied by steps towards monetary union, certain precautionary arrangements in the field of non-monetary policy-making are needed and thus form indispensable elements of an economic union. Without such additional safeguards the successful functioning of monetary union could not be ensured.

As already pointed out in the 1970 Werner Report, an economic union implies first of all the realisation of a single market within which persons, goods, services and capital can move freely and without distortion of competition. The creation of this market presupposes a "level playing field" for all residents of the Community, which allows them to make decisions on production, investment and consumption in broadly similar conditions and on the basis of similar levels of information. To this end all barriers which tend to separate markets along national borders have to be eliminated. In particular, all technical and regulatory obstacles have to be removed, standards have to be harmonised or mutually recognised and tax treatment must not discriminate in favour of or against economic activities across Community countries. These requirements can only be met if all policies affecting competitiveness are decided collectively by all

concerted

principle of subsidiarity

member countries and if adequate provision is made to monitor and enforce a uniform application of agreed standards and regulations throughout the Community. Given that certain aspects of social policy, as well as of consumer and environmental protection, can also significantly influence competitive conditions, certain common minimum standards in these fields also have to be agreed at the Community level. Finally, a single market requires that taxation and other revenue measures affecting the flow of goods and services do not provide differing incentives to economic activity in individual member countries - unless such incentives are deliberately part of the Community's regional or structural policies.

The establishment of the single market in conjunction with a monetary union has important implications for the working and the management of the economy of the Community. Most importantly, adjustment of economic imbalances that could emanate from excessive wage claims in one member country or from external shocks with differing repercussions on individual economies can no longer be supported by exchange rate realignments. The equilibrating role of exchange rates has to be taken over by market mechanisms operating through differential wage changes and movements of labour. While the removal of obstacles to the free flow of persons, goods, services and capital will certainly reinforce such self-regulatory market forces, additional measures to enhance the effectiveness of market mechanisms will be needed. In particular, complementary action is required to increase wage and price flexibility, ensure wage-setting procedures based on productivity developments and strengthen the regional and occupational mobility of labour. [Reference to income policies?] [Section on social dimension?]

However, even if the effectiveness of market mechanisms is strengthened over time, this will not suffice to cope with problems generated by structural divergences between member countries or prevent the emergence of new imbalances in the wake of changes in competitiveness; nor will market forces alone impose adequate constraints on national budgetary policies and thereby help to avoid fiscal imbalances that could jeopardise monetary stability or produce disequilibria in the real economy or the financial sector of the Community. For these reasons the existence of a single market in conjunction with a monetary union needs to be flanked by safeguards and appropriate institutional arrangements (discussed in Section 4) in at least two non-monetary areas.

accompanying cyclical + structural policies

Firstly, the single market may tend to aggravate the differences between Community countries with higher and lower levels of economic development and could possibly lead to economically and politically undesirable dislocations of industries and labour forces. Market forces would - at least in the short run - exacerbate rather than mitigate the differences between poorer and richer member countries and cause serious strains and frictions in the Community. In order to be able to address the problem of structural differences between member countries and concomitant disparities in levels of per capita income, the Community must possess a system of financial transfers. This arrangement must aim at both tempering existing inequalities of standards of living and actively promoting structural development in countries with low per capita incomes. An important step in this direction has been taken in connection with the decisions considerably to enlarge the resources of the Community's structural funds and to reorganise structural policies. The effectiveness of the system of transfers is partly a question of its endowment with financial resources, but also of its ability to implement effective programmes for the improvement of productive capacity through investment in such areas as physical infrastructure, communication and education. Moreover, as long as wage flexibility and labour mobility have not increased considerably, changes in competitiveness in different regions of the Community could lead to relatively large declines in output and employment in areas with deteriorating competitiveness. In order to avoid undue social and economic tensions and temporarily to ease adjustment burdens, it might be necessary to organise financing flows through official channels which would play a role similar to that of conditional balance-of-payments assistance available under present monetary arrangements.

The second important area in which safeguards are needed is the realm of budgetary policies. In an environment of fully integrated markets and monetary union, unco-ordinated national budgetary policies might undermine monetary stability, generate imbalances in the real and financial sectors of the Community and render it difficult, if not impossible, to pursue appropriate macro-economic policies for the Community as a whole. The seriousness of these adverse effects will depend to some extent on the disciplinary influence that market forces can exert on budgetary policies decided independently at national levels, as well as on the size of the

Community's own budget. Experience suggests that the constraints resulting from different interest rates on similar types of government securities - reflecting the markets' assessment of the soundness of budgetary policies - are likely to be weak and to work only slowly. Moreover, even upon completion of economic and monetary union, the Community's budget is likely to remain small and would therefore not be a suitable vehicle for compensating the fiscal stance adopted by national governments. For these reasons arrangements have to be made which allow a close and flexible co-ordination of national fiscal policies aimed in two directions.

The first aim must be to set up arrangements which will effectively limit the scope for budget deficits that can be incurred by individual member countries of the Community. Safeguards in this respect will have to include (in accordance with the criteria laid down for a European system of central banks) strict ceilings on the maximum permissible access to monetary financing, as well as on borrowing in non-Community currencies. In addition, agreement must be reached on a system of binding rules which limits the maximum size of national budget deficits [in relation to GDP? Confining deficits to investment spending?]. The second aim of arrangements in the fiscal field must be to enable the Community to conduct a coherent mix of fiscal and monetary policies, i.e. to dispose of a system of rules that can be applied with a view to determining the aggregate balance on national budgetary positions, including that of the Community.

[Given that a single market necessitates a close harmonisation of the base and the rates of indirect taxation, a harmonisation of corporate taxes and therefore, by implication, also a certain alignment of income taxes, there will be a marked convergence in the revenue structure of all national budgets. At the same time, the expenditure pattern might also converge; for instance, an economic union requires some broad alignment of social security expenditures. Finally, there is a crucial need to develop a system of binding rules for policy purposes. All these developments raise the question of whether, rather than proceeding in a piecemeal fashion, it would not be more appropriate to consider the idea of a European fiscal system. A proposal in this direction could outline the principles of a comprehensive set of fiscal arrangements relating to both national and Community budgets and covering such matters as the size of deficits, their

financing, essential tax harmonisation, the respective roles of national and Community budgets, "own" resources of the Community budget, etc.]

In summary, an economic union implies the creation of a single market in the Community. The decision to this effect has already been taken and the process of removing all types of barriers separating the economies of member countries is under way. This will provide a significant impetus to economic growth and improvements in the standard of living of the Community's residents. In combination with monetary union the internal market's potential for growth will certainly be enhanced further, but will also entail serious risks for a balanced economic development and the functioning of the monetary union itself. For this reason adequate safeguards are needed in two non-monetary areas: the Community has to set up a system of financial transfers and to introduce arrangements which allow an effective co-ordination of and control over national budgetary policies.

4. Institutional arrangements

Management of the economic and monetary union calls for an institutional framework which will allow an efficient and democratic decision-making in those economic areas that are of direct concern to all member countries of the Community. The realisation of economic and monetary union, therefore, requires the establishment of decision-making centres which, to the extent necessary, will take over functions previously performed by national institutions.

The creation of a monetary union necessitates the setting-up of a new monetary institution, placed properly in the existing structure of Community institutions (European Council, Council of Ministers, European Parliament, Commission and Court of Justice). The implementation of economic union, too, requires institutional arrangements which enable policies in non-monetary fields to be determined or co-ordinated. [This latter task can be carried out by existing Community institutions provided their functions and responsibilities are appropriately expanded.]

The need for a new monetary institution arises because one monetary policy cannot be decided and implemented independently by different central banks and because decisions over day-to-day operations of monetary policy must be centralised in order to be able to respond quickly

to changing market conditions. For these reasons both the conduct of the Community's domestic monetary policy and the implementation of the Community's international monetary policies must be organised in a European system of central banks. The system should consist of a Federal European Monetary Institution (FEMI) and national central banks. At the final stage the FEMI would be responsible for the formulation of the thrust of monetary policy in the medium term, the execution of the Community's exchange rate policy vis-à-vis third currencies and the co-ordination of short-term action (such as the adjustment of interest rates and other policy instruments). The national central banks would be entrusted with the implementation of these policies in accordance with guidelines established by the FEMI.

[The Committee is firmly of the view] that the European system of central banks, which embodies the Community's monetary order, must be built on the following basic principles:

- the mandate of the system must be to maintain the stability of money as the prime objective of the Community's monetary policy. While fulfilling this task, the system has to support the general economic policy of the Community. Stability of the currency in terms of prices must take precedence over exchange rate stability;
- the system must be independent of instructions from national governments and Community authorities. This requirement is deemed necessary partly in order to enable the system to pursue a stability-oriented monetary policy without being subjected in the short run to political influences; but the need for independence also derives from the practical consideration that in a federally organised Community there is not only one government alone that could oversee the operations of the system; at the same time, however, the system should be subject to democratic control and therefore be accountable for its actions and policies; [How? Does the formulation of the mandate suffice? Should there be regular reporting? On what? To whom? Council of Ministers? Monetary Affairs Committee of the European Parliament?]
- the system must reflect the federal structure of the Community. This implies an organisation [perhaps analogous to the US Federal

Reserve System] which, through appropriate representation [and weighted voting procedures] in governing bodies, ensures that the interests of all national central banks are adequately taken into account. To this end the organisational structure of the system could consist of a Board and a Council. The Board would have [three] members and a Chairman, all of whom would be working full time for the FEMI and not hold responsibilities in national institutions. The Board members would be appointed for a term of office of [eight] years by the European Council. The Board would be responsible for the day-to-day management of the FEMI and be supported by its own staff. The Council would ~~include~~ be composed of the Board members as well as the Governors of the national central banks and act as the policy-making authority. The Council would meet regularly [every two weeks] and be chaired by [the Chairman of the Board] and its decisions would be made on the basis [of weighted voting reflecting the relative importance of national central banks?]. The meetings of the Council could be attended by a member of the Commission [Council of Ministers?], who, however, would not have the right to vote; [Role of the Committee of Governors? of the Monetary Committee?]

- strict limitations must be imposed on the system's capacity to grant directly (or indirectly via national central banks) credit to public authorities, including Community authorities, in order to safeguard the system's ability to conduct an independent monetary policy geared towards price stability;
- the monetary policy instruments of the system must be aligned in such a way as to enable a monetary management without recourse to quantitative controls or other forms of direct intervention in the functioning of the financial markets;
- in accordance with the traditional and generally accepted task of central banks to ensure the safety and balanced development of the financial system, the European system of central banks would be responsible for a smooth functioning of financial markets in the Community. In order to play this macro-prudential role the system would have to exercise supervisory functions and should therefore at least take part in the process of establishing general regulations in the field of banking supervision.

The need for a <u>Centre for economic policy decisions</u> in the Community derives from a number of different considerations: firstly, a common unrestricted market demands broadly uniform rules and regulations which can be decided, implemented and enforced effectively only at the Community level. Secondly, regional and structural policies across the national borders of member countries must be decided collectively, with limited financial flows being channelled through the Community's budget. Thirdly, in accordance with the federal structure of the Community, budgetary policies will remain predominantly a preserve of national authorities; the Community budget consequently will account only for minor shares of overall revenue flows and public spending. Given the potential impact of national budgetary policies on the real economy and the financial markets of the Community, and given also the necessity to design a macro-economic policy for the Community as a whole, there is a clear need for institutional arrangements which permit an effective co-ordination of national budgetary policies.

The diversity of non-monetary policies in which the Community needs to be involved to varying degrees must be reflected in the institutional structure of the Centre for economic policy decisions. It does not require a new institution but rather a reinforcement of, and adequate amendment to, the existing arrangements through which the Community can shape economic policies. An efficient and coherent economic management will be based on a blend of rules and discretion and therefore necessitate a reorganisation of the interrelationships between, and a redistribution of the tasks performed by, the Commission, the Council and the European Parliament.

The procedures and arrangements for the implementation of a single market for persons, goods, services and capital have been laid down in the Treaty of Rome and the Single Act, conferring upon the Community the executive and judiciary authority to put the internal market programme into operation. To fulfil this programme on schedule, however, the Community will still have to accomplish a heavy legislative task, covering certain controversial areas such as the harmonisation of indirect taxation. Moreover, to overcome a potentially serious problem of non-compliance with the growing body of Community legislation in support of the integrated internal market, it will be necessary to increase the effectiveness of the

process whereby the Community law is enforced. [Any need for additional institutional measures?]

The foundations for a more effective Community role in regional and structural policies have been put in place recently. The programme of doubling the resources of structural funds to ECU 13 billion per year by 1992, coupled with the reorganisation of the Community structural policies, significantly improves the ability of the Community to deal with these problems. However, the Committee considers that in a more advanced stage of the process these mechanisms should be further extended and made more effective. [The Committee may wish to indicate how this should be done, in both quantitative and qualitative terms; moreover, is there any need for additional institutional measures?]

In order to enable the Community to co-ordinate its member countries' fiscal policies, new procedures will have to be developed which result in a joint decision-making on the overall stance of fiscal policy, i.e. the size and the financing of the aggregate budgetary position in the Community. In addition, the Community must be given the possibility to influence directly [perhaps through a system of binding rules which can be waved/applied by collective decisions?] the budgetary position of individual member countries. ... [Which institutional measures are needed? A revision of the 1974 convergence decision? Move to a European Fiscal System?]

5. How to proceed?

The implementation of economic and monetary union must, in accordance with Article 236 of the Treaty of Rome, be embodied in a new Treaty. While the legal requirements for the attribution of the necessary policy responsibilities to the Community can be established in a relatively short period, the actual implementation of full economic and monetary union will need much more time and can in practice be achieved only in stages and through interaction between market forces and official action. Two alternative routes to economic and monetary union are conceivable.

The first alternative is to conclude a new Treaty each time a political consensus to advance one step has been reached. This procedure has the advantage of clearly laying open at each step the political commitment to European integration and offering a high degree of

flexibility and scope for pragmatic headway. At the same time, however, this approach is not only rather unwieldy and bound to be slow, it also carries the risk that, with focus on pragmatic considerations, sight may be lost of the ultimate objective. Moreover, while there is no doubt that upon completion of the process of integration all countries will benefit greatly from economic and monetary union, each time a decision on a new step is to be made without a firm view of the ultimate goal short-term cost considerations may be weighed against uncertain longer-term benefits and thus hamper the process of integration.

For these reasons preference should be given to a second alternative, i.e. concluding a comprehensive single new Treaty which would formulate clearly ~~and in detail~~ the features and institutional arrangements of economic and monetary union as described in the preceding sections. The Treaty would facilitate the implementation process through enabling clauses which, provided such clauses could be activated only on the basis of [unanimous] agreement, would safeguard fully the interests of each member country. Such a procedure would allow all member countries of the Community to express their agreement with the final objective of European integration while, at the same time, it would not necessitate that each step be carried out simultaneously by all countries, thus leaving room for longer transition periods for countries not yet in a position to take the step. The ratification of the Treaty would represent in itself an important first step, demonstrating strongly the political will to attain economic and monetary union. Moreover, the Treaty would then serve as a visible landmark on the way to integration against which the consistency and conformity of each individual step with the final objective could be checked.

II. The present state of economic and monetary integration in the Community

(to be drafted)

III. Concrete steps towards economic and monetary union

1. Principles governing a step-by-step approach

The request made by the European Council to the Committee to study "concrete steps" reflects the awareness that an economic and monetary union, as outlined in Part I of this Report, is too profound a change in the economic and institutional structure of the Community to be realised at one stroke. Households, corporations, unions and public administrations will need time to adapt their economic behaviour to a new setting. Similarly, it will not be possible to attribute new powers to the Community at once in all fields. Rather, it will be necessary to build on success and to retain the possibility of correcting the course of action in the light of new experiences.

For these reasons the process of implementing economic and monetary union will have to be divided into a limited number of clearly defined stages. Each stage will have to represent a significant change with respect to the preceding one. New arrangements coming into force at the beginning of each stage will gradually develop their effects and bring about a change in economic reality so as to pave the way for the next stage.

The Committee is of the view that a number of considerations have to be taken into account in designing a step-by-step approach to economic and monetary union.

A first consideration concerns gradualism and indivisibility. While the arguments above point to the need for gradualism, it has to be recognised that policy decisions and operational responsibilities are, in certain specific areas, not divisible. They cannot be transferred "piece by piece" but require a quantum jump. Unless it is clearly indicated who (i.e. whether national governments or the Community; which organ or institution) has "the last word", policy conflicts will inevitably arise.

A second and related consideration concerns parallelism. Parallel advancement in many interrelated areas is an indispensable prerequisite for the avoidance of imbalances which could cause economic disruptions and loss of political support for the continuing process of developing the Community into an economic and monetary union. Perfect parallelism, however, at each

and every point of time is impossible and could even be counterproductive. Already in the past the advancement of the Community in certain areas has been combined with temporary standstill in others, thus involving a process of only partial parallelism. A certain amount of temporary deviations from parallelism should be part of the dynamic evolutionary process of the Community. However, parallelism has to be maintained in the medium term.

A third consideration concerns participation. There is one Community, but not all the members have participated fully in all its aspects from the beginning. So far this has mainly been the consequence of successive enlargements and, for the EMS, of the decision of some countries not to join the exchange rate agreement. A consensus on the final objectives of the Community, as well as membership of the same set of institutions, should be maintained, while allowing for a degree of flexibility concerning the date on which some member countries join certain arrangements. The management of each set of arrangements should be the responsibility of those who fully participate in it.

A fourth consideration concerns the calendar and the timing. The Committee considers that the conditions for reaching the final stage are too difficult and depend on too many factors to permit a firm announcement of an explicit deadline. It has also to be considered that each stage contains a programme of legislative actions that takes time to implement, as well as that there is a need to test the arrangements established at the beginning of the stage. Thus a certain degree of flexibility in the calendar is necessary. However, a clear commitment to the final stage, as described in Part I, is indispensable and there should be at least an indication of the timing of the first step.

Taking these considerations into account the Committee feels that a step-by-step approach should be founded on two basic principles: firstly, following a first step which is possible on the basis of the existing Treaty, a new Treaty would be concluded in accordance with Article 236 of the Treaty of Rome. The new Treaty would provide the legal basis for all the actions and developments which are necessary for reaching the final stage of the economic and monetary union. Given the decision in favour of a gradualistic approach, many clauses of the Treaty would come into force only at later stages. This approach has been adopted in the past by the Community and appears to be suited to putting the process of economic and

monetary integration on a firm footing and giving it the necessary credibility and safeguards.

Secondly, the Treaty will indicate the procedures whereby the decision will be taken to move from one stage to the next. On the one hand, the signing of the Treaty will represent a single political decision embracing the whole enterprise of economic and monetary union and commitment thereto. On the other hand, every passage from one stage to the next will require an appraisal of the situation and [unanimous] political agreement. [Should unanimity be adopted as the rule for all the stages? Who should participate in the decision? Which body or bodies will take the decision? The European Council may have to take the final decision, but what say will the organs of the economic institution and monetary institution respectively have in proposing, or giving advice on, this decision?]

2. Three concrete steps

What follows is a hypothesis of how to arrive at economic and monetary union in three steps. Each step would be the "entry point" to a new stage of the process leading to the economic and monetary union. [Such a provisional hypothesis has been formulated on the basis of documents presented to the Committee to date, and in accordance with the suggestion made at the November meeting that the first step could essentially consist of an upgrading of the Committee of Governors and the second of the creation of a new institution to which some reserves and some initial operational responsibilities would be entrusted.]

(a) Stage one [to be enacted in conjunction with the coming into force of the directive on short-term capital movements]

In the institutional field:

- preparation and ratification of the Treaty on the economic and monetary union.

In the economic field:

- complete removal of internal barriers and liberalisation of exchanges of goods, services and capital within the Community, according to the single market programme adopted in the Single Act;
- complete implementation of the "Brussels package" of doubling the structural funds, designed to strengthen substantially the ability of Community policies to promote regional development and to correct economic imbalances;
- replacement of the 1974 Council Decision on economic convergence by a new procedure for budgetary policy co-ordination. This would be based on quantitative guidelines [expressed as a percentage of GDP], aimed at assessing fiscal performances and, where such developments are judged inadequate, triggering consultations and performance clauses of the same kind as those applying to conditional Community credits.

In the monetary field:

- the coming into force of the June 1988 directive liberalising monetary movements in July 1990 will establish a regime of complete freedom of capital transactions. During this first stage a directive would be adopted to harmonise tax treatment of capital revenues to the extent that is necessary to avoid distortions in capital flows;
- the 1964 Council Decision defining the mandate of the Committee of Central Bank Governors would be replaced by a new decision giving the Committee greater authority and visibility and making it the forerunner of the Council of the European system of central banks to be created under the new Treaty. The Committee:
    - would be responsible for discretionally setting the interest rate to be charged on financing extended to member central banks under the very short-term and short-term EMS credit mechanisms;
    - would be consulted in advance of national decisions concerning the setting of yearly targets of domestic monetary policy;

- would have the authority to make policy recommendations to the Council of the Community, ~~as well as to member countries.~~ The outcome of its consultations, together with a periodic assessment of monetary policies, could be made public;

- a permanent staff would be constituted to prepare the deliberations of the Committee and to support its consultations and public declarations. The deliberations of the Committee would not be binding for member central banks;
- in the course of stage one all the necessary directives to liberalise the market for banking and other financial services would have to be approved, as planned under the programme for the completion of the internal market. A sub-committee of the Committee of Governors would start regular consultations concerning matters of common interest in the field of banking supervision;
- margins of fluctuation would be narrowed from 2.25 to 1(?)%.

(b) Stage two [to be enacted when the new Treaty comes into force]

In the economic field:

- completion (if ~~not yet achieved in stage one~~) of the internal market programme, including the strengthening of Community competition policy and of the executive and judiciary authority to identify and sanction infringements of Community law;
- the Centre for economic policy decisions (CEPD) would start operating with a view to promoting convergence and co-ordination of economic policy in the Community. [Following the programme set out in the new Treaty, legislative and executive measures would be taken, at the Community as well as the national level, leading to the creation of a European Fiscal System (EFS). Such a system, as specified below, would cover:

  - essential tax harmonisation;
  - the respective roles of national and Community budgets;
  - "own" resources of the Community budget;

- the size of budget deficits and their financing;]

- [in accordance with the programme for the EFS,] introduction of improved procedures and actions and enlargement of resources for structural policies of the Community which will accompany and supplement structural policies carried out by member countries; strengthening of Community investment programmes in the fields of research and infrastructure;
- [in accordance with the programme for the EFS,] introduction of binding ceilings on external borrowing and monetary financing of domestic budgetary deficits; joint adoption of budgetary objectives as part of a co-ordinated budgetary policy.

In the monetary field:

- creation of the European system of central banks (ESCB) described in Part I of this Report, with its central body (the Federal European Monetary Institution - FEMI), decision-making organs (Board and Council), balance sheet, and legal underpinnings: mandate to preserve price stability, independence, accountability, decision-making procedures. The institution would incorporate the present monetary arrangements (EMCF, Committee of Governors, competence over the ECU, etc.). In the initial stage of the new institutional setting created in accordance with the Treaty on economic and monetary union, the ESCB's tasks would be confined to limited actions in the field of exchange rate management, while domestic monetary policies would be conducted by national central banks under a procedure for co-ordination and consultation (see below);
- the actions of the FEMI in the field of foreign exchange management would be restricted to exchange market interventions, and would essentially serve two purposes: to create a "training ground" for the future role of the system and to give to markets signals of concerted interventions. In order to fulfil this task the FEMI would hold and manage a small amount of reserves. To this end the FEMI should have its own balance sheet, separated from those of member central banks. It would contain on the asset

side official reserves, which would be definitively pooled and result from the contribution by each member country of convertible currencies other than its own, denominated both in Community and third currencies. Other assets would consist of credits extended to member central banks, reflecting the FEMI's power to grant discretionary loans which would take the place of existing credit mechanisms (except for the very short-term financing). On the liability side the FEMI's balance sheet would have ECU liabilities to member central banks;

- the FEMI could conceivably assume [three] functions:

  - interventions in third currencies;
  - entitlement to conduct intra-EMS interventions;
  - [representation of the Community in international monetary meetings, for instance in discussions with the United States and Japan;]
  - [two hypotheses can be put forward about the scope of foreign exchange operations conducted by the FEMI, depending on how important a role the FEMI should play at this intermediate stage. According to a first (<u>soft</u>) hypothesis, the Board of the FEMI would intervene only on the basis of case-by-case approval received in the concertation procedure by member central banks (Council of the ESCB). According to a second (<u>hard</u>) hypothesis interventions by the FEMI would be left to the discretion of the Board, which would base its decisions on monthly guidelines established by the Council of the system. In either case the overall size of FEMI interventions would be small - at least initially - and not imply a significant shift of the intervention policy from the network of national central banks to the FEMI. Consideration could also be given to the idea of implementing the soft and the hard hypothesis at different junctures in the course of this stage two;]

- in the field of <u>domestic monetary policy</u> the FEMI would:

- act as the forum for [binding?] ex ante co-ordination of national annual monetary targets and decisions in the process of monetary policy implementation;
- refrain from fulfilling any operational function.

[N.B. Owing to the small size of FEMI interventions and to the firm control exercised by the Council, the impact of foreign exchange operations on domestic monetary conditions of member countries should be negligible. In any case national central banks would be free to offset their effect on internal liquidity by open market operations or other domestic measures.]

- The development of the ECU: the preparation of the final stage of the monetary union, when the ECU would become the single currency of the Community, could follow one of the two alternative routes outlined in Part I. One would be to set up an autonomous process of money creation for the ECU, entrusted to the European system of central banks and parallel to the process of money creation for national currencies. The other route would be to confine the ECU, until the last stage, to the role of a mere "denomination" but to permit economic agents to continue the long process of getting acquainted with the name and approximate value of the future common currency, to use it (if market participants so choose) to set prices, to keep corporate accounts and to label any kind of pecuniary obligation. To this end all regulatory impediments that may now prevent a more widespread use of the ECU as a denomination should be removed.

(c) Stage three [this corresponds to the final stage described in Part I. It should be observed that the so-called "final stage" is not necessarily a stage beyond which the system would not be susceptible to further evolution. Rather, it is one in which the fundamental requirements of an economic and monetary union would have been fulfilled, albeit in a setting that might be subject to changes and improvements.]

In the economic field:

- the Centre for economic policy decisions would be given the authority to impose constraints on national budgets when this is necessary to prevent imbalances that may threaten monetary stability, or when it is required for the achievement of a desirable policy mix for the Community as a whole.

In the monetary field:

- parities would be irrevocably locked and the European system of central banks would start operating with full competence for the monetary policy decisions of the Community, as described in Part I.

(d) Last stage

- the ECU replaces national currencies.