COMMITTEE FOR THE STUDY OF
ECONOMIC AND MONETARY UNION

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II. How to define 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.

The establishment of economic and monetary union will transform the Community into a single economy, circumscribed by the existence of a single currency area, a single market and an institutional and functional framework for economic management. However, even after a single economy has been realised, the Community will continue to consist of independent nations with differing traditions, social customs and languages. The existence and preservation of this heterogeneous structure necessitates that a large degree of autonomy in economic decision-making will rest with individual member countries and that a balance will be struck between national and Community interests. For this reason it is not possible simply to model an economic and monetary union for the Community on the example of existing economies, but it is necessary to develop an innovative and unique solution.

The solution will have to be embodied in a new Treaty which clearly lays down the basic functional and institutional arrangements as well as provisions governing their step-by-step implementation on the way to economic and monetary union. An essential element of this solution is the distribution of economic policy responsibilities within the Community in strict conformity with the principle of subsidiarity. The attribution of competences to the Community must be narrowly confined to those areas in which a collective decision-making is necessary, whereas all policy functions which can be carried out at national (or local) levels without adverse repercussions on the cohesion and functioning of the economic and monetary union must remain in the competence of the member countries. A need for Community decisions arises primarily - though to different degrees - in the field of macro-economic management. As a monetary union requires a single monetary policy the responsibility for the formulation of this policy as well as decisions on day-to-day operations must be centralised in one decision-making body. In the field of fiscal policy the need for centralisation is less stringent and in accordance with the principle of subsidiarity a wide range of budgetary decisions should be left to national authorities. At the same time, however, all member countries will have to recognise and accept in their decision-making the existence of the constraints on national fiscal policy that emanate from participation in an economic and monetary union.

A gradual step-by-step approach to implementing an economic and monetary union can be set out only if there is a clear understanding of its concept, its implications for the working of the economy and economic decision-making and of the principal elements that have to be in place for its successful and durable functioning. Economic union and monetary union are closely intertwined and form two integral parts of a single whole and must therefore be implemented in parallel. It is for reasons of expositional clarity that the following sections look separately at the principal features defining an economic and a monetary union. This description begins with the concept of a monetary union, chiefly because an economic union can be circumscribed more clearly and specifically in the context of monetary union.

2. The principal features of monetary union

A monetary union describes a single currency area, which as already stated in the 1970 Werner Report, is realised when three conditions are fulfilled:

- 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. A single currency area will, however, have been accomplished only when in the final stage the decisive step is taken to lock irrevocably the exchange rates between Community currencies. This step presents the single most important measure delineating the establishment of a single currency area, but it would not necessarily mark the end of the process of monetary unification in the Community. In fact, the Committee strongly endorses the idea that the ECU should become the future currency of the Community and that an official declaration to this effect should be made at the time of concluding a new Treaty. Such a declaration would mean that ultimately the existing national currencies will be replaced by the ECU which will serve as the only means of payment, unit of account and store of value for all residents of the Community. The transition to a single currency would, however, be possible only some time after exchange rates have been locked and when market forces have fostered a spreading use of the ECU in commercial and financial transactions. [Section on the maintenance of the ECU as a basket?]

The permanent freezing of exchange rate relationships will significantly contribute to a growing degree of substitutability between national currencies. As a result, interest rates on comparable financial instruments, irrespective of the national currency in which they are denominated, will tend to converge and differences between prices of tradable goods will largely disappear. However, the pace with which these developments take place will depend critically on the credibility that the decision to lock exchange rates enjoys in the market place. Initially, the continuing existence of national currencies may cast doubt on the commitment to unchangeable exchange rate parities and engender market perceptions of differences between individual currencies' quality and standing. Both, a coherent monetary management and convincing evidence of an effective co-ordination of non-monetary policies will play a crucial role in dispelling such doubts over time. [Section rejecting a parallel currency approach?]

The creation of a single currency area composed of national currencies will have far-reaching consequences for the formulation and operations of monetary policy in the Community. The adoption of fixed exchange rates in an environment of free and fully integrated capital and money markets implies the need for a single monetary policy and therefore a shift of responsibility from national central banks to a European system of central banks. This new framework will not only provide the institutional setting (the principal features of which are outlined in Section 4) for a centralised and collective decision on the monetary policy stance of the Community, but it will also possess the necessary financial attributes (i.e. its own balance sheet) and the regulatory powers to enforce the pursuit of the Community's monetary policy in a system of freely circulating national currencies. One possibility for managing a common monetary policy might be to employ the official ECU as a common reserve instrument which, firmly controlled by a central monetary institution, would determine the scope for national monetary expansion in line with the Community's monetary policy stance. [Could another possibility be that one of the existing national currencies is chosen as the anchor of the system and managed collectively in the framework of the European central bank system?]

The shift from national monetary policies to a single monetary policy is an inescapable consequence of entering a monetary union. However, the resultant incision in the manner in which monetary policy is conducted will in practice 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 a completely autonomous monetary policy at the national level has been rendered much more 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 effective if instruments of policy are harmonised and if broadly compatible objectives are pursued.

The decision to lock irrevocably exchange rate parities between national currencies will affect profoundly the functioning and the performance of the economies in the Community, generating significant advantages but entailing also disadvantages.

The most significant gain of monetary union is the removal of exchange rate uncertainties and a lowering of costs of transactions between residents of different countries in the Community. This will generate stimulatory effects on trade and contribute to a more efficient allocation of resources, and thereby raise the level of economic activity and employment in the Community. At the same time, with parities frozen, movements of exchange rates unwarranted by fundamental factors can no longer be a source of macro-economic disturbances and competitive distortions. Moreover, once the locking of exchange rates has gained credibility in the market place, market participants in all countries are likely to behave more conformably and will thereby contribute to the evolution of a more homogeneous economic structure in the Community. Finally, the creation of a single currency area in combination with an unrestricted common market means that the Community will be much less susceptible to external shocks.

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 and - to the extent that market mechanisms do not perform an adequate equilibrating role - the burden of adjustment will fall on other policies, such as income, fiscal and structural policies. For this reason, as discussed in the next section, the implementation of a monetary union must be accompanied by parallel progress in creating or strengthening effective alternative adjustment instruments. Moreover, while the freezing of exchange rate relationships will not eliminate the possibility of current-account imbalances in individual Community countries, the statistical measurement of such imbalances may become more difficult in a fully integrated market and balance-of-payments disequilibria could no longer manifest themselves in exchange rate pressures. Indeed, national current-account imbalances would essentially assume the meaning of regional imbalances. As a consequence, both balance-of-payments figures and exchange rates which represent currently two highly visible and sensitive indicators of policy-induced disequilibria would no longer be able to play a significant role as guideposts for policy-making. However, the balance between the economic benefits and costs of exchange rate fixity will become more and more favourable as the Community develops into an optimum currency area. In order to tilt the balance in this direction it is indispensable that the move towards monetary union is coupled with measures designed to strengthen the mobility of factors of production and a close co-ordination of non-monetary policies.

In summary, the realisation of a monetary union means that in a situation of free capital movements and full financial integration the exchange rates between Community currencies are irreversibly fixed. This will create a single currency area in which, at least initially, all national currencies circulate freely although they might eventually be replaced by the ECU as the single Community currency. The transition from a situation of fixed but adjustable exchange rates to a system of permanently locked exchange rates implies a fundamental change in the economic management of the Community. National monetary policies will have to give way to a single monetary policy for the Community as a whole, being formulated and executed jointly in the context of a European system of central banks. At the same time, a single currency area implies the abandonment of the exchange rate as an instrument of adjustment for imbalances among Community countries and therefore requires, in parallel to the process of monetary integration, measures to co-ordinate effectively policies in non-monetary areas.

3. The principal features of economic union

The realisation of an economic union in the Community involves simultaneous action on three fronts: the creation of a unified and unrestricted market, common policies directed towards an optimal utilisation of resources and arrangements guaranteeing a high degree of co-ordination of national economic policies. These three elements reinforce each other and are necessary for an efficient working of the economic union. At the same time, given the interdependence between real and monetary developments and the interactions between economic and monetary measures, common policies effected at the Community level and a close co-ordination of national policies are also indispensable for the cohesion and stability of a monetary union. Without adequate constraints on non-monetary policies and appropriate measures to correct market imperfections it would be impossible to maintain permanently fixed exchange rates between Community currencies.

The creation of a single market in Europe will impart strong impulses to economic growth and increase economic welfare through both, a further specialisation in line with countries' and regions' comparative advantages and the exploitation of economies of scale in production, research and marketing. These gains will materialise as the residents in the enlarged market without internal frontiers will respond to price, wage and interest rate movements, which, transmitted throughout the Community, will provide significant incentives for a more efficient allocation of resources. While there is no doubt that this process will stimulate economic activity and employment for the Community as a whole, greater economic freedom and intensifying trade in goods and services in a situation of irrevocably locked exchange rates will also entail certain economic risks. The removal of physical, technological and regulatory barriers will, on the one hand, increase economic freedom and strengthen the play of market forces, but on the other hand, experience has shown that as a consequence of many imperfections market mechanisms do not work smoothly and do not always produce satisfactory results within reasonable periods of time. The danger that self-regulatory market forces fail to bring about an economically and politically acceptable adjustment to disturbances is heightened by the fact that, upon entering monetary union, the Community can no longer avail itself of exchange rate realignments as an instrument in support of adjustment. Economic imbalances emanating from labour and other cost developments in one member country, external shocks with differing repercussions on individual economies, or divergent non-members' policies pursued at national levels can therefore not be corrected by exchange rate changes but, as pointed out in the previous section, will have to be eliminated largely by other policy measures. Only if such imbalances can be reduced rather quickly or their emergence be avoided altogether will it be possible to sustain permanently fixed exchange rates without undue economic costs in the form of marked pressures on output and employment in certain regions of the Community.

It is primarily for these reasons that the creation of an economic union in conjunction with monetary union requires action in three interrelated areas: a set of measures designed to reduce market imperfections and to strengthen to the extent possible the functioning of a larger market without internal frontiers; common policies to enhance the process of resource allocation in those areas where the working of market forces needs to be reinforced or complemented; and adequate arrangements which allow both, to limit the possibility of divergences between national non-monetary policies and to design a macro-economic policy mix for the Community as a whole.

The measures aimed at strengthening market mechanisms are to a large extent envisaged in the Single Act establishing a frontier-free 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 certain common minimum standards governing social policy and consumer and environmental protection have to be agreed. Moreover, tax treatment must not discriminate in favour of or against economic activities across Community countries. At the same time, competition policy - conducted at the Community level - has to operate in such a way that access to markets is not impeded and market functioning not distorted by the behaviour of private or public economic agents.

Beyond clearly formulated policies to dismantle barriers and to prevent restrictive practices efforts may also have to be made to encourage in all countries the adoption of wage-setting procedures which are based on productivity developments and to strengthen the regional and occupational mobility of labour.

While measures to safeguard an undistorted common market will reinforce the role of the market mechanism in the Community, market forces cannot be expected to lead, on their own, to an optimal allocation of resources and a balanced distribution of wealth throughout the Community. Common policies to guide and complement market forces are needed in a wide range of areas, such as agriculture, industry, transport, research and development and, in particular, regional and structural development. Unless the move to economic and monetary union is postponed until such a distant date at which all Community countries have reached a broadly similar stage of development, the creation of a single market and the locking of exchange rates will expose regions with ill-adapted structures and lower productivity to strong and possibly unsustainable competitive pressures. Regional disparity may therefore at least in the short run be aggravated rather than mitigated. If undue economic and political tensions arising from dislocations of industries and labour forces are to be avoided, common efforts will have to be made to enable the Community's less developed regions to catch up with the wealthier ones. To this end, the Community must develop an effective policy and be endowed with adequate financial resources which allow it to assist regional development efforts undertaken at national levels. An important step in this direction has been taken in connection with the decision considerably to enlarge the resources of the Community's structural funds and to reorganise structural policies. The principal objective of these policies would not be to subsidise incomes and simply temper inequalities in standards of living but to help to equate the conditions for production through investment programmes in such areas as physical infrastructure, communication, transportation and education. The success of these policies hinges not only on the size of the available financial resources, but to a decisive extent also on the effectiveness of the investment programmes. A longer-term approach in this area will offer countries with lower levels of productivity an appropriate period of transition and in this sense constitutes an essential element of the policy mix to ensure continuing economic integration and the attainment of economic and monetary union.

Furthermore, 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 ease temporarily 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.

While economic union necessitates that policies to ensure a proper distributional and allocative functioning of the market without frontiers are formulated and, in part, executed at the level of the Community, adherence to the principle of subsidiarity implies that many other non-monetary policies will continue to be carried out under the sole competence of national authorities. This applies most importantly to budgetary policies which, apart from the relatively small Community budget, will remain the preserve of member states even at the time of the final stage of economic and monetary union. However, even with budgetary decisions being taken at national levels, all countries will have to accept that sharing a common market and a single currency area imposes narrow constraints on their national budgetary policies and requires strict fiscal discipline. An economic and monetary union can only operate on the basis of solidarity and prudent fiscal behaviour on the part of all member countries. Unco-ordinated and divergent national budgetary policies could not only undermine monetary stability, but would also 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.

To some extent market forces will exert some disciplinary influence on fiscal policies as market participants' assessments of the soundness of individual countries' budgetary positions would give rise to differences between interest rates on broadly similar types of government securities. However, experience suggests that market perceptions of official borrowers' creditworthiness do not alter in a way which would provide strong and compelling signals to national authorities. Rather than leading to a gradual adaptation of borrowing costs, market views tend to change abruptly and result in the closure of access to market financing. The constraints imposed by market forces are thus likely either to be too slow and weak, or too sudden and disruptive. For this reason an economic and monetary union requires arrangements which effectively ensure a close and flexible co-ordination of national fiscal policies.

The first aim of fiscal policy co-ordination 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 limits 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. The second aim of the co-ordination 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.

In summary, the realisation of an economic union in conjunction with monetary union implies: the creation of a common, unrestricted market; common policies at the level of the Community which will help to exploit the full potential of the single market and its role in the allocation of resources, but which will also assist regions with lower productivity to catch up with the richer parts of the Community; and arrangements which will allow a close and effective co-ordination of national fiscal policies, both to avoid undesirable repercussions on monetary policy and distortions in real and financial markets, and to enable the Community to pursue a policy mix aimed at economic stability and growth. These requirements have to be met not only to derive the greatest possible benefit of an enlarged economic space, but they are also indispensable for the cohesion of the monetary union.

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 creation of a monetary union necessitates the setting-up of a new monetary institution, placed properly in the constellation of Community institutions (European Council, Council of Ministers, European Parliament, Commission and Court of Justice). The implementation of economic union does not require a new institutional setting, but in order to formulate and implement common policies in non-monetary fields and to co-ordinate policies under the competence of national authorities, a revision and, possibly, some restructuring of existing Community institutions might be envisaged.

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 Community's domestic and international monetary policy must be organised in a European system of central banks. The system could consist of a Federal European Monetary Institution (FEMI), with its own balance sheet, and national central banks. At the final stage the FEMI would be responsible for the formulation of the thrust of monetary policy, 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 European system of central banks, which embodies the Community's monetary order, should be built on the following basic principles:

- a federative structure of the central bank system, since this corresponds best to the political structure of the Community (e.g. a European Central Bank Council (ECBC) representing all the central bans in the union);
- a centralised body (Directorate) responsible for the implementation of ECBC decisions as far as they apply at Community level;
- responsibility of national central banks for policy implementation at regional level;
- 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 will be responsible for the formulation of monetary policy at the Community level, for the co-ordination of policy implementation at the regional level and for the preservation of a properly functioning payments system. The instruments at its disposal will be enumerated in the statute of the system with a procedure for amending this enumeration;
- the system will be responsible for the formulation of banking supervisory policy at the Community level and co-ordination of banking supervision policies of the national supervisory authorities;
- independence of instructions from national governments and Community authorities;
- a proper democratic legitimisation which might be effectuated through regular reporting to a committee of the European Parliament and through the European Parliament taking part in the appointment procedures with regard to the members of the Directorate;
- supervision of the administration of the system independently of the Community organisations, for example, by a supervisory council or a committee of independent auditors;
- strict limitation of lending to all public authorities;
- equipment with monetary policy instruments that are oriented towards a free market economy;
- nomination of members of the Directorate for relatively long periods on an irrevocable basis;
- seat of the institution.

The institutional requirements for an effective conduct of non-monetary policies should be assessed in the light of the functions which will be performed at the Community level. As pointed out in the previous section, there are three broad areas in which the Community has to be involved: firstly, the establishment and maintenance of a single market for persons, goods, services and capital; secondly, the formulation and implementation of common policies aimed at strengthening the process of resource allocation; and thirdly, co-ordination of national fiscal policies with a view to promoting prudent fiscal behaviour, avoiding inappropriate divergences between national fiscal policies and formulating a macro-fiscal policy stance of the Community.

The necessary institutional framework for performing these three tasks is already in place with different, though partly overlapping, functions being conferred upon the Council, the European Parliament, the Commission and the Court of Justice. In order to ensure a flexible and effective conduct of policies in those non-monetary areas in which the Community is involved, two basic requirements have to be fulfilled: firstly, to the extent that policies are decided and enacted at the Community level, there must be a clear distribution of responsibilities among the existing Community institutions, with due regard to whether decisions relate to the setting of broad policy directions or to day-to-day operations in the light of current developments. Secondly, in those areas in which the Community's role is restricted to the co-ordination of national policies, its task must be guided by a system of rules which are accepted by, and can be applied to, individual member states.

In order to be able to carry out the functions within the existing institutional framework, the Community bodies must possess adequate instruments and means. As far as the implementation of the single market is concerned, the necessary procedures and arrangements 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.

With regard to common policies aimed at resource allocation, foundations for a more effective Community role in regional and structural policies have been put in place recently, involving both a doubling of the resources of structural funds and a reorganisation of policies. At a more advanced stage of the process these mechanisms might be further extended and made more effective.

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 this context the Community must be given the possibility to influence directly the budgetary policies of individual member countries through a system of rules and by collective decisions. However, given the fact that the ultimate budgetary decision-making power will rest with national parliaments, the system of rules will serve essentially as a framework for increasing the transparency of the co-ordination process which, for example, through public announcement of limits on budgetary positions, could help to exert greater peer pressure.

While the involvement of the Community in non-monetary policies will be based on the existing institutional setting, it is paramount that the ensuing policy decisions result in a coherent and consistent set of measures which clearly signal the Community's policy stance. Without an unequivocal formulation of non-monetary policies, most of all in the fiscal field, the responsibility for macro-economic policy for the Community as a whole would fall virtually entirely on the European system of central banks. This would not only cede too great a responsibility to the monetary authorities, it would also leave the Community with a single macro-economic policy tool and therefore significantly impede an effective policy geared towards stability and growth.