From the purely presentational point of view, the use of Arabic numerals for both section headings & paragraphs is not ideal.
Perhaps at least the section headings could be in BOLD print.

Change ECU to ecu in Delors report.

I have "concrete steps" leading up to my conclusion!

M.

COMMITTEE FOR THE STUDY OF
ECONOMIC AND MONETARY UNION

CSEMU/12/88
24th February 1989
Draft

R E P O R T O N

E C O N O M I C A N D M O N E T A R Y

U N I O N I N E U R O P E

Foreword

cf. p 10. At its meeting in Hannover on 27th ~~to~~ 28th June 1988 the European Council recalled that, in adopting the Single Act, the Member States of the Community had confirmed the objective of progressive realisation of economic and monetary union. The Heads of State and Government therefore decided to examine at the European Council meeting in Madrid in June 1989 the means of achieving this union. To that end they decided to entrust to a Committee, chaired by Mr. Jacques Delors, President of the European Commission, the cf. p. 30 "concrete steps" task of studying and proposing concrete stages leading towards this union.

In response to this decision by the Heads of State and Government, the Committee has the honour to submit the attached Report. The ideas expressed and the proposals contained in the Report are given on the personal responsibility of the members of the Committee.

The Report is organised in three main parts. The first one examines the present state of and perspectives for economic and monetary integration in the Community. The second part describes the principal features of the final stage of economic and monetary union, and the third C 3? part makes concrete proposals with regard to steps which could lead the Community in three stages to economic and monetary union.

Table of contents

Page

I. <u>The present state of and perspectives for economic and monetary integration in the Community</u>

1. Introduction

1. Efforts in the Community to progress towards full economic and monetary integration began in earnest as the Bretton Woods system was breaking up. The Werner Report on the realisation by stages of economic and monetary union was drawn up in 1970. This initiative took place against the background of the end of the transition period leading to the completion of the customs union, and of the definition of the common agricultural policy. It presented a first attempt to define and set out a plan for the attainment of economic and monetary union.

By the mid-1970s the perception had grown that the process of integration had lost momentum under the pressure from the divergent policy reactions to the economic crises occurring at the time. Nevertheless, several important institutional moves had been made: in 1972 the "Snake" was created; in 1973 the European Monetary Co-operation Fund (EMCF) was set up; and in 1974 the Council Decision on the attainment of a high degree of convergence in the Community and the Directive on stability, growth and full employment were adopted.

2. In 1979 the process of monetary integration was relaunched with the creation of the European Monetary System (EMS) and the ECU. The success of the EMS in promoting its objectives of internal and external monetary stability laid the foundations for the new impetus to European integration in recent years, as reflected in the adoption of the 1992 internal market programme and the signing of the Single European Act.

(copy in Table of Contents)

The fact that the 1992 internal market process has now become practically irreversible proves that the Community has been able to overcome the serious problems of the 1970s and has coped with the enlargements resulting from the accession of new member countries. The idea of economic and monetary union has been revived now that the Community has put its house in order and resolved the most urgent budgetary and policy issues. The Community is once more progressing along the path of economic and monetary integration.

2. The European Monetary System and the adjustment of the European economy

3. In the monetary field a new phase in the process towards an economic and monetary union opened with the creation of the European Monetary System at the end of the 1970s. The progress made by the Community in the 1980s towards price stability, growing monetary co-operation and greater economic integration owed much to the EMS.

4. Within the framework of the EMS the Community has developed into a zone of increasing monetary stability while gradually relaxing capital controls. This achievement was particularly remarkable in a period in which the world economy was shaken by wide exchange rate fluctuations and tensions in trade relationships. The acceptance of the exchange rate constraint has greatly helped the participating countries in gearing their monetary policy towards the objective of price stability, thereby laying the foundations for both a converging price performance at a low rate of inflation and the attainment of a high degree of exchange rate stability. The greater priority attached to a policy of monetary stability has promoted in many countries a moderation in cost increases and led to an improvement in the overall economic performance. Moreover, the reduced uncertainty about exchange rate developments and the fact that the parities of the participating currencies were not allowed to depart significantly from the fundamental economic factors facilitated and strengthened intra-European trade, even at times of severe economic difficulties and high unemployment.

The EMS has served as a focal point for improved monetary policy co-ordination and provided a basis for multilateral surveillance within the Community. Its success is in part attributable to the willingness of countries to opt for a strong currency policy stance, but also to the flexible and pragmatic way in which the System has been managed. The EMS has evolved in response to changes in the economic and financial environment and on two occasions (Palermo 1986 and Basle-Nyborg 1987) its mechanism has been amended and improved.

5. An important element in the launching of the European Monetary System was the creation of the ECU. In setting up the EMS, the European

Council declared in 1978 that "a European currency unit (ECU) will be at the centre of the EMS". Apart from being used as the numeraire of the exchange rate mechanism and as a denominator for operations in both the intervention and credit mechanisms, the ECU serves primarily as a reserve asset and a means of settlement for EMS central banks. To fulfil this latter function a stock of official ECUs has been created through revolving swap arrangements whereby participating central banks maintain 20% of their gold and dollar reserves with the European Monetary Co-operation Fund. Although it is an integral part of the EMS and despite a number of measures to improve its usability, the ECU has so far played only a limited role in the functioning of the EMS.

10 By contrast, the ECU has gained remarkable popularity in the market place where its use as a denomination ~~of~~ for financial transactions has spread significantly. A wide set of ECU instruments is now available for investors, both at the short and at the long end of the market. In international banking the ECU ~~occupies~~ is at present the ~~place of the~~ sixth most important currency of denomination and it ranks fifth in international bond issues, with a 6% market share. The growing use of the ECU reflects in part the interest of public sector borrowers ~~to~~ in developing and tapping the market for ECU securities, but it must also be attributed to an important extent to the ECU's attractiveness as a means of portfolio diversification and as a hedge against currency risks. Moreover, the creation of an ECU clearing system two years ago, in which ~~by~~ now more than thirty commercial banks participate, has contributed to the development and the liquidity of the ECU market. In the non-financial sphere, however, the use of the ECU for the invoicing and settlement of commercial transactions remains limited, covering at present only about 1% of the Community countries' external trade. ~~However,~~ Nevertheless opinion polls, especially among firms, tend to show an increased interest in the potential uses of the ECU.

3. The Single European Act and the Internal Market Programme

10 6. On the economic side, a "relaunching" of Europe began in the mid-1980s supported by the success of the EMS. The central element in this process was the proposal, made in May 1985 by the Commission, to realise the objective of a market without internal frontiers by 1992. The essence of the measures for the removal of physical, technical and tax barriers was

set out in a White Paper, which specifies the programme, timetable and methods for creating a unified economic area in which persons, goods, services and capital will be able to move freely. This objective, together with the necessary institutional steps, was embodied in December 1985 in the Single European Act which marked the first significant revision of the Treaty of Rome.

7. The Single Act signalled two significant changes in the Community's strategy ~~to~~ for advanc~~e~~ing in the integration process. Firstly, it incorporated an institutional reform aimed at establishing a faster, more efficient and more democratic decision-making process which was considered to be indispensable for reaching the goal of a common, unrestricted market. In particular, this reform extended the scope of qualified majority voting and thereby removed the constraints inherent in the permanent search for consensus which had hampered the decision-making process in the past, gave the European Parliament a greater role in the legislative process, and greatly simplified the requirements of harmonising national law by limiting harmonisation to the essential standards and by systematic adoption of mutual recognition of national norms and regulations. Secondly, with the Single Act the member countries reaffirmed - and recognised in the context of the Treaty of Rome - the need to strengthen the Community's economic and social cohesion, to enhance the Community's monetary capacity in the perspective of economic and monetary union, to reinforce the Community's scientific and technological basis, to harmonise working conditions with respect to health and safety standards, to promote the dialogue between management and labour, and to initiate action to protect the environment.

8. Considerable progress has been made over the last three years in implementing the internal market programme. This highlights a marked change of pace in approaching a unified market, as compared ~~to~~ with the developments during the previous two decades.

The realisation of the internal market ~~until~~ By 1993 involves the adoption of some 300 Directives. In view of the time required for them to be transposed into national legislation, the bulk of the Community's legislative work should be completed by the end of 1990. In three years the Commission has presented 90% of the proposals for the Directives concerned and the Council has adopted around one-half. The most prominent, and certainly one of the most important, examples is the Directive on the liberalisation of capital movements which was adopted within six months and ~~which~~ will come into force on 1st July 1990. Another step in the direction of greater financial integration was the adoption of the Directive establishing the freedom to provide insurance services for industrial risks. This Directive applies the principle of mutual recognition. Rapid and significant progress has also been made in removing technical barriers relating to machines, materials, foodstuffs, public works and supply contracts, sea, air and road transport and financial services, but the abolition of tax barriers and physical barriers has advanced less quickly so far.

9. The creation of a single market is, however, not solely based on the elimination of micro-economic market barriers but comprises also a range of measures to avoid market segmentation through restrictive commercial practices and dominant market positions, as well as common policies aimed at reducing market imperfections. In the field of competition policy, the Commission's ability to apply Community law governing the internal market will be strengthened, various measures will be implemented to increase the transparency, efficiency and legal certainty of the procedures of the Community's competition policy and a court of first instance, specialising in particular in competition questions, will be established alongside the European Court of Justice.

As far as complementary common policies are concerned, the European Council approved in February 1988 a package of measures which dealt with both the most urgent and ? delicate (?) arduous European policy issues and will Community policies directed at eliminating market imperfections and safeguarding the economic and social cohesion of the Community. The package included three major elements. Firstly, measures to reform the common agricultural policy in the light of new production and trade conditions. Secondly, the adoption of a new financial regime which provides a firm footing for Community activities on the basis of a system of own resources. Thirdly, a considerable improvement in the Community's capacity to influence structural developments in the single market. Most importantly, the structural funds will be doubled by 1993, which ~~and~~ together with a reorientation of policies away from project to programme financing, will enable the Community to promote more effectively growth and adaptation in less developed regions and a restructuring of declining industries. Moreover, with the adoption of a framework programme for research and technological co-operation the Community will be able to strengthen the scientific and technological foundations of European industry and help them it to exploit the advantages of an enlarged market.

4. Perspectives, opportunities and problems

10. The European Council, meeting in Rhodes in December 1988, noted that "at the halfway stage towards the deadline of December 1992, half of the legislative programme necessary for the establishment of the large market is already nearly complete" and underlined "the irreversible nature of the movement towards a Europe without internal frontiers". There is, indeed, widespread evidence that the objective of a single market enjoys broad support by consumers and producers and that their economic decisions are increasingly influenced by the prospects of 1992. Anticipation effects are clearly reflected in the investment strategies of European firms and the unprecedented number of mergers foreshadowing [a] growing industrial co-operation. These developments have generated a new dynamism and certainly contributed to the recent acceleration of economic growth in the Community.

11. The single market will entail profound structural changes in the economies of the member countries. The abolition of market barriers will link national economies much more closely together and significantly increase the degree of economic integration within the Community. These changes offer immense opportunities for economic advancement but many of the potential gains can only materialise if economic policy-making is adjusted in response to the structural changes. The opportunities arise because the unified enlarged economic space greatly increases the freedom of choice of market participants, generates considerable Large possibilities for exploiting economies of scale and comparative advantages and reduces the administrative costs of intra-Community trade. There can be no doubt that these changes prepare the ground for a more efficient use and allocation of resources with beneficial effects for trade, growth and employment. However, the extent to which these gains can be achieved depends critically on the degree of certainty surrounding the decision-making of private

market participants. The single market will greatly strengthen economic interdependence between member countries and amplify the cross-border effects of development originating in each member country. If national policies are not brought in line the participants in the single market will be facing conflicting signals which will not only create an unfavourable climate of uncertainty, but over time will give rise to economic imbalances which might necessitate more frequent exchange rate realignments or recourse to safeguard clauses. The existence of a common market in which separate national authorities determine economic policies thus imposes a strong constraint on their room for independent manoeuvre and requires a high degree of policy co-ordination. This is most obviously the case in the field of monetary policy where in a situation of freedom of capital movement and integrated financial markets incompatible national policies would translate quickly into exchange rate pressures. But it also applies to all other areas of national economic management.

Even close co-operation between national authorities can, however, not ensure that the efficiency gains from a unified market will be evenly distributed among all member countries. Common policies conducted at the Community level in support of a broadly balanced development and an equitable distribution of prosperity are therefore an indispensable complement to a single market. Indeed, the need to back up the removal of market barriers by a strengthening of common regional and structural policies was clearly recognised in the Brussels package of measures agreed in February 1988.

12. As the success of the internal market programme hinges to a decisive extent on more effective Community policies as well as a close co-ordination of national economic policies, it implies that in essence a number of the steps towards economic and monetary union will already have to be taken in the course of establishing a single market in Europe. As will be discussed in Part II of the Report, an economic and monetary union encompasses a common market for persons, goods, services and capital, a single currency area and a set of arrangements designed to ensure a coherent and effective economic management for the Community as a whole. In this sense economic and monetary union will add to the internal market programme two principal elements. Firstly, it will set up explicitly a policy framework which will replace the present ad hoc procedures for

voluntary policy co-ordination by a system defining clearly the distribution of policy responsibilities exercised at the Community and the national levels, and thereby guarantee a consistent economic management. Secondly, it will create a single currency area through an irrevocable locking of exchange rates or the introduction of a single currency, and thereby enhance strongly the potential of the single market. Although in many respects a natural sequence to the commitment to create a market without internal frontiers, the move towards economic and monetary union represents a quantum jump which will secure a significant increase in economic welfare in the Community.

13. The <u>benefits of economic and monetary union</u> would derive from three interrelated developments. Firstly, the strengthening and expansion of common policies pursued at the Community level would help to correct market imperfections which operate on a Community-wide scale and could therefore not be satisfactorily dealt with at a national level. This applies to research and development where Community policies would promote the pooling of resources, help to avoid duplication and facilitate the dissemination of information. Similarly, common industrial policies could prevent competition among national incentive schemes which, without a certain degree of intervention at the Community level, would tend to neutralise each other and lead to a waste of scarce economic resources. Large productivity gains for the Community as a whole could also be achieved by organising on a Community scale the provision of cross-border public goods such as infrastructure for transportation, the environment and long distance energy transmission. Finally, and perhaps most importantly, the Community structural policies would help to develop a more balanced economic structure throughout the Community and thereby prevent the emergence or aggravation of regional and sectoral imbalances.

14. Secondly, a <u>closely co-ordinated management of macro-economic policies</u> is not only vital for the cohesion of an economic and monetary union, but it also offers the possibility of systematically exploiting the reciprocal room for manoeuvre under a co-operative strategy and attaining a higher rate of growth and employment. Within a clearly defined framework for policy-making the interdependence of economic developments in individual member countries would be automatically taken into account and

would

thereby ensure the most favourable outcome from the interactions of national policies. For instance, the Cecchini Report estimated that the impact of the internal market programme on growth in the Community could be raised by 2½ percentage points if the removal of market barriers were accompanied by an active macro-economic policy in the Community. An economic and monetary union would greatly enhance the chances for implementing such a well co-ordinated, growth-oriented strategy.

15. Thirdly, in leading to a <u>single currency area</u> an economic and monetary union would establish the conditions under which a common market could fully develop its potential. As a single currency area would imply the permanent fixing of exchange rates - or the adoption of a single currency - participants in the single market would benefit ~~strongly~~ considerably from three developments: exchange rate uncertainties with regard to intra-Community transactions would be eliminated, the cost of transactions between residents of different Community countries would be reduced and the transparency of prices and, therefore, the pressure to avoid price discrimination would be increased. These three consequences would not only provide greater certainty for economic decisions and planning, they would also reinforce strongly the competitive forces of a common market and enhance its allocative function. The existence of irrevocably fixed exchange rates would, moreover, dispel fears of a devaluation, and market participants would cease to seek compensation for anticipated exchange rate depreciation in the form of higher wage claims or higher interest rates. As a consequence, cost pressures would be reduced and interest rates would converge in a downward direction. Finally, as a single currency area the Community would be much less susceptible to external economic shocks.

The adoption of permanently fixed exchange rates would, however, eliminate an important indicator of policy conflicts among Community countries and remove the exchange rate as an instrument of adjustment from the Community's set of economic tools. Economic imbalances among member countries, reflecting either a differing response of individual economies to disturbances from outside the Community, or divergent cost developments within the Community, would therefore have to be corrected by policies affecting directly the level of real wages, if major regional disparities in output and employment were to be avoided. The abandonment of the exchange rate instrument would constitute the single most significant change on the way to economic and monetary union, but the resultant loss of the degree of freedom would be alleviated in an economic and monetary union by the availability of common Community policies and a high degree of national policy co-ordination. Indeed, external shocks would normally not affect the entire economy of a single member country, but rather manifest themselves in specific industrial sectors throughout the Community, and the appropriate remedial action would be in the form of structural policies instead of exchange rate change. Sizable imbalances among Community countries would only emerge if individual countries embarked on incompatible policy courses, but if this were possible for any extended period, policy co-ordination would have failed and the very foundations of an economic and monetary union would have been destroyed.

16. The move to economic and monetary union would also increase considerably the Community's weight in the world economy, strengthen its role in international concertation and give it a substantial influence on the management of the world economy and the international monetary system. The Community's enhanced capacity for negotiation and action could make a significant contribution to a high level of activity in the world economy, with beneficial effects for growth in Europe.

17. Economic and monetary union has been set as a goal by the Community since the late 1960s. The single market, by itself, does not require the establishment of an economic and monetary union. It requires, however, a significant increase in the degree of economic policy co-operation even in areas that are not, as such, part of the single market programme. Such an increase will represent~~s~~ ~~a~~ significant progress along ~~on~~ the path leading to an economic and monetary union. This is the reason why the European Council in Hanover ~~has~~ decided to give further stages question ~~consider again~~ the ~~problem~~ of an economic and monetary union and the steps leading to it. These matters form ~~are~~ the subject ~~matters~~ of Parts II and III of this Report.

internal (?)

Same? ✓

/ ✓ (Eng. spelling!)

II. The final stage of economic and monetary union

1. Introduction

18. Economic and monetary union in Europe would imply complete freedom of movement for persons, goods, services and capital, as well as irrevocably fixed exchange rates between national currencies or a single currency. This, in turn, would presuppose a high degree of integration and require a common monetary policy and consistent economic policies. In the Community these policies would be geared towards price stability, balanced growth and converging standards of living, high employment and external equilibrium. Economic and monetary union would represent the final result of the process of progressive economic integration in Europe.

19. The EC Treaties, as amended by the Single European Act, would provide the legal foundation for many of the necessary steps towards economic integration. However, the existing Treaties do not suffice for the creation of an economic and monetary union. The realisation of this objective would call for new arrangements which could only be established on the basis of a new Treaty and consequent changes in national legislations. For this reason the union would have to be embodied in a Treaty which clearly la~~ys~~id down the basic functional and institutional arrangements, as well as provisions governing their step-by-step implementation.

20. Even with a single market, a unified monetary system and an institutional and functional framework for economic management, the Community would continue to consist of independent nations with differing economic characteristics, traditions, social customs and languages. The existence and preservation of this plurality and diversified structure would necessitate that a degree of autonomy in economic decision-making continued to rest with individual member countries and that a balance ~~would be~~ were struck between national and Community competences. In fact, there is no precedent in modern history for the creation of an economic and monetary union in the absence of, or before reaching, political union. For this reason it would not be possible simply to model an economic and monetary

union for the Community on the example of existing federal states; it would be necessary to develop an innovative and unique approach.

An essential element of any approach consistent with the historical and economic conditions in member countries would be the distribution of economic policy responsibilities within the Community in strict conformity with the constitutional "principle of subsidiarity". According to this principle, the functions of higher levels of government should be as limited as possible and should be subsidiary to those of lower levels. Thus, the attribution of competences to the Community would have to be confined to those areas in which collective decision-making ~~were~~ was necessary, whereas all policy functions which could be carried out at national (or local) levels without adverse repercussions on the cohesion and functioning of the economic and monetary union would have to remain within the competence of the member countries.

With due regard to the principle of subsidiarity and taking into account what is already provided for in the EC Treaties, the need for policy decisions to be taken at the Community level would arise primarily in the field of macro-economic management. A monetary union would require a single monetary policy and the responsibility for the formulation of this policy would consequently have to be vested in one decision-making body. In the field of fiscal policy a wide range of budgetary decisions would be left to national authorities, but the decision-making would have to be placed ~~into~~ within a framework of binding rules which would enable the Community to determine an overall fiscal policy stance, avoid major differences in public sector borrowing requirements between individual member countries and observe certain constraints with regard to the financing of budget deficits.

21. A step-by-step approach to implementing an economic and monetary union can be set out only if there is a clear understanding of this final objective, of its implications for the working of the economy and economic policy decisions, and of the principal elements that would have to be in place for its successful and durable functioning. Economic union and monetary union are closely intertwined, form two integral parts of a single whole and would therefore have to 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 once the main elements of a monetary union have been identified.

2. The principal features of monetary union

22. A monetary union describes a single currency area in which policies are managed jointly with a view to attaining common macro-economic objectives. As already stated in the 1970 Werner Report, there are three necessary conditions for a monetary union:

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

The first 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. The basic conditions for a monetary union would, however, be accomplished only when the decisive step ~~were~~ was taken to lock irrevocably the exchange rates between Community currencies. This would be the single most important step towards creating a situation in which all currencies could be used equally to set prices, make payments and denominate debts or credits.

As a result of the permanent fixing of exchange rates, national currencies would become increasingly closer substitutes and their interest rates would tend to converge. However, the pace with which these developments took place would depend critically on the extent to which firms, households, labour unions and other economic agents were convinced that the decision to lock exchange rates would not be reversed. Initially, the continuing existence of national currencies might leave doubts about the commitment to unchangeable exchange rate parities and could engender market perceptions of differences between individual currencies' quality and standing. Both coherent monetary management and convincing evidence of an effective co-ordination of non-monetary policies would be crucial in dispelling such doubts over time.

23. The three above-mentioned requirements are necessary for the establishment of a single currency area, but their implementation would not necessarily mark the end of the process of monetary unification in the Community. At a later stage the adoption of <u>a single currency</u>, while in principle not strictly necessary for the creation of a monetary union, might be seen - for economic as well as psychological and political reasons - as a natural and desirable further development of the monetary union. A single currency would clearly demonstrate the irreversibility of the move to monetary union, ~~greatly~~ considerably facilitate the monetary management of the Community and have a much ~~higher~~ greater weight in international markets than any individual Community currency. In this connection, it would be desirable to endorse the idea that the ECU should develop into the future currency of the Community and that an official declaration to this effect should be made at the time of the decision to draw up a new Treaty. This declaration would imply that there should be no discontinuity between the present ECU and the future single currency, i.e. that any debt contracted in ECU before the introduction of the single currency would be payable at face value in ECU if, at maturity, the transition to the single currency had been made. While the Treaty should allow for an appropriate period of transition, this would mean that ultimately the ECU would replace existing national currencies and serve as a means of payment, unit of account and store of value for all residents of the Community. The introduction of a single currency would, however, be possible only some time after exchange rates had been locked, when economic agents had become sufficiently acquainted with the ECU and when its use in commercial and financial transactions had spread.

Ls

Ls

24. The establishment of a monetary union would have far-reaching implications for the formulation and execution of monetary policy in the Community. Once permanently fixed exchange rates had been adopted, but national currencies continued to exist in an environment of free and fully integrated capital and money markets there would be ~~the~~ a <u>need for a single monetary policy</u> to be carried out through new operational procedures and not simply through the co-ordination of as many national monetary policies as

there were currencies participating in the union. This, in turn, would require the attribution of ~~the~~ responsibility for monetary policy to a new institution, the European System of Central Banks (the principal features of which are outlined below in Section 4), which would not only form the basis for centralised and collective decisions on the expansion of money and credit in the Community, but would also possess the necessary financial attributes (i.e. its own balance sheet) and the regulatory powers to enforce implementation of the chosen policy. In designing the necessary operational framework, particular attention would thus have to be given to two essential requirements. Firstly, an agreement would have to be reached on an unambiguous procedure for setting specific objectives of the Community's aggregate monetary policy; and secondly, instruments would have to be developed to ensure ~~with which~~ the compliance of national monetary authorities with the commonly taken decision ~~could be ensured~~.

This shift from national monetary policies to a single monetary policy is an inescapable consequence of entering a monetary union and would mark one of the principal institutional changes required by economic and monetary union. In practice, however, the incision would not be so deep, but rather would represent 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~~ would have created a situation in which the co-ordination of monetary policy ~~will~~ would strengthen progressively. 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 the effectiveness of national monetary policies will become increasingly dependent upon co-operation among central banks. Indeed, the growing co-ordination of monetary policies will make a positive contribution to financial market integration and will help central banks to gain the experience that is necessary for moving to a single monetary policy.

Tense?

25. As has been pointed out in Part I of this Report, the decision to lock exchange rate parities between national currencies irrevocably would have <u>profound effects</u> on the functioning and the performance of the economy of the Community.

A monetary union would remove exchange rate uncertainties and lower transactions costs, eliminate the possibility of movements of exchange rates unwarranted by fundamental factors, contribute to the evolution of a more homogeneous economic structure in the Community and reduce the susceptibility of the Community to external shocks.

At the same time, with parities irrevocably fixed, foreign exchange markets would cease to provide a source of pressure for policy corrections when economic disequilibria developed and persisted. Moreover, while the exchange rate could no longer serve as an instrument for adjusting economic imbalances among member countries, there would still be the possibility of divergences between the supply of and demand for economic resources in individual Community countries. However, the statistical measurement and the economic interpretation of such imbalances might become more difficult and balance-of-payments disequilibria would essentially reflect regional imbalances in a fully integrated market. As a consequence, balance-of-payments figures, which are currently a highly visible and sensitive indicator of economic disequilibria, would no longer La play such a significant role as guidepost for policy-making.

However, the balance between the economic benefits and costs of exchange rate fixity would become more and more favourable as the Community developed into an economic and monetary union. In order to tilt the balance in this direction it would be essential that the move towards monetary union ~~were~~ should be coupled with measures designed to strengthen the mobility of factors of production and a close co-ordination of economic policies.

26. In <u>summary</u>, the realisation of a monetary union would mean that in a situation of free capital movements and full financial integration the exchange rates between Community currencies would be irreversibly fixed. This would create a monetary union in which, at least initially, all national currencies circulated freely, although they might eventually be replaced by the ECU as the sole Community currency. The transition from a situation of fixed but adjustable exchange rates to a system of permanently locked parities would imply a fundamental change in the economic as well as

the monetary management of the Community. National monetary policies would have to give way to a single monetary policy for the Community as a whole, formulated and executed jointly in the context of a European System of Central Banks. At the same time, a single currency area would imply the abandonment of the exchange rate as an instrument of adjustment of imbalances among Community countries and would therefore require, 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

27. Economic union combines the characteristics of an unrestricted common market with a set of rules which are indispensable for its proper working. In this sense economic union can be described ~~by~~ in terms of four basic elements:

- the single market within which persons, goods, services and capital can move freely;
- competition policy and other measures aimed at strengthening market mechanisms;
- common policies aimed at structural and regional development; and
- binding rules for budgetary policies.

In identifying the content and limits of specific rules defining the policy framework of an economic union, the Community should be guided by two considerations.

Firstly, the economic union should be inspired by the same "market economy" principles that constitute the foundation of the economic order of its member countries. Differences in policy choices may exist between member countries or - within the same country - in different periods. However, beyond such differences, a distinctive common feature of economic systems in Europe is the combination of a large degree of freedom for market behaviour and private economic initiative with public intervention in the provision of certain social services and public goods. Within this broad conception, the scope for attributing to the Community economic functions that are at present exercised at national levels should be limited by adherence to the principle of subsidiarity.

Secondly, an appropriate balance between the economic and the monetary components should be ensured for the union to be viable. This would be essential because of the close interactions between economic and monetary developments and policies. A coherent set of economic policies at the Community and national levels would be necessary to maintain permanently fixed exchange rates between Community currencies; and conversely, a common monetary policy in support of a single currency area would be necessary for the Community to develop into an economic union.

We've had "EC Treaties": Should this be EEC Treaty, EC Treaties, or specific (Treaty of Rome?) cf. p. 25

28. The measures aimed at <u>creating the single market</u> are to a large extent envisaged in the <u>EC Treaty</u> and the Single Act. With their implementation, by 1992, all barriers which tend to separate markets along national borders will be eliminated. In particular, all technical and regulatory obstacles will be removed, norms will be harmonised or mutually recognised, and certain common minimum standards governing social policy and consumer and environmental protection will be agreed. Moreover, national tax treatment will be partly harmonised to avoid severe distortion in the competitiveness of industries operating in different countries of the Community.

The creation of a single market 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 respond to price, wage and interest rate movements, which, transmitted throughout the Community, will provide important incentives for a more efficient use of economic resources. There is no doubt that this process will stimulate economic activity and employment in the Community as a whole, and will generate greater economic freedom and increased trade in goods and services.

29. As has been discussed in Part I of this Report the single market in combination with irrevocably fixed exchange rates or a single currency would benefit from a monetary environment of greater certainty that would further enhance the advantages of an enlarged economic space (area (?)). However, as previous historical experience has shown - it would also encounter <u>certain economic constraints</u>, ~~due to the fact that~~ since exchange rate realignment would

no longer be available as an instrument to correct economic imbalances. Such imbalances might arise because the process of adjustment and restructuring set in motion by the removal of physical, technological and regulatory barriers is unlikely to run smoothly or always produce satisfactory results within reasonable periods of time. Imbalances might also emanate from labour and other cost developments in one member country, external shocks with differing repercussions on individual economies, or divergent non-monetary policies pursued at national levels. As was pointed out in Part I, in a monetary union such imbalances would have to be detected and eliminated rather quickly, or their emergence be avoided altogether, in order to make it possible to reap the benefits of economic union without undue costs in the form of marked pressures on output and employment in certain regions of the Community.

30. It is primarily for these reasons that the creation of an economic and monetary union would need to complement the creation of a single market through <u>action in three interrelated areas</u>: competition policy and other measures aimed at strengthening market mechanisms; common policies to enhance the process of resource allocation in those economic sectors and geographical areas where the working of market forces need~~s~~ed to be reinforced or complemented; and binding rules in the budgetary field and other arrangements both to limit the scope for macro-economic divergences between member countries and to design an overall economic policy framework for the Community as a whole.

31. <u>Competition policy</u> - conducted at the Community level - would have to operate in such a way that access to markets ~~were~~ would not be impeded and market functioning not be distorted by the behaviour of private or public economic agents. Such policies would have to address conventional forms of restrictive practices and the abuse of dominant market positions, but would also have to deal with new aspects of antitrust laws, especially in the field of merger and takeover activities. In particular, attention would have to be paid to the problem of excessive government subsidies in favour of certain industries, since state aids ~~do~~ not ~~merely~~ only distort competition but result in the longer run in an inefficient use and allocation of scarce economic resources.

In addition to clearly formulated policies for the dismantling of barriers and the prevention of restrictive practices, efforts would also have to be made to convince European management and labour of the advantages of gearing wage policies largely to improvements in productivity and thus to contribute or accept, a uniform minimal rate of price increase at the Community level. Governments for their part, on their behalf should strengthen tendencies towards reducing or completely eliminating direct intervention into the wage and price formation process.

32. <u>Community policies in the regional and structural field</u> would be of paramount ~~imperative~~ importance in order to promote an optimum ~~optimal~~ allocation of resources and a balanced distribution of wealth throughout the Community. Without adequate consideration for regional imbalances, the economic union would be faced with grave economic and political risks. For this reason particular attention would have to be paid to an effective Community policy aimed at cushioning regional and structural disparities and promoting a balanced development throughout the Community. In this context the regional implications of other Community policies would have to be taken into account.

The creation of a single market and the locking of exchange rates would take place in a situation in which owing to ill-adapted structures and differences in productivity, some major regional disparities would still exist. The impact of economic and monetary integration on these disparities could differ considerably and might therefore be difficult to assess: on the one hand, economic integration would provide less developed regions with lower wage levels with an opportunity to attract modern and rapidly growing service and manufacturing industries for which the choice of location would not necessarily be determined by transport costs and market proximity. On the other hand, however, transport costs and economies of scale would tend to favour a shift in economic activity away from less developed regions, especially at the periphery of the Community, to the highly developed areas in its centre. The economic and monetary union should avoid undue economic and political tensions arising from possible dislocations of industries and labour forces. Therefore, it would have to encourage and guide structural adjustment which would help the Community's poorer regions to catch up with the wealthier ones. To this end, the Community would have to develop pursue further an effective policy and be endowed with adequate financial resources ~~which would~~ to allow it to ~~assist~~ support regional development efforts undertaken at national levels.

A step in this direction was taken in February 1988 when the European Council decided to strengthen and reorganise the Community's regional policies in two respects: the size of structural funds will be doubled over the period ~~leading~~ up to 1992, and emphasis will be shifted from project to programme financing. In the process of creating economic and monetary union such policies would have to be strengthened further after 1992.

The principal objective of regional policies should not be to subsidise incomes and simply temper inequalities in standards of living but to help to equalise ~~the~~ conditions for production through investment programmes in such areas as physical infrastructure, communication, transportation and education so that large-scale movements of labour ~~would~~ do not become the major adjustment factor. The success of these policies ~~would~~ will hinge not only on the size of the available financial resources, but to a decisive extent also on their being used efficiently ~~use~~ and with due regard to the profitability of the investment programmes. Indeed, the more recent experience of countries inside and outside the Community has shown that structural and regional development programmes ~~were~~ have been particularly successful when improvements in the resource base of regions encouraged by investment in infrastructure and education ~~were~~ have been reinforced by decentralised initiatives for local entrepreneurship, modernisation of urban areas and local institutional arrangements favouring development. A long-term approach would offer countries with lower levels of productivity an appropriate period of transition and in this sense would constitute an essential element of the policy mix to ensure continuing economic integration.

As was mentioned above, for a satisfactor~~ily~~y balanced to be achieved in regional development would also ~~have to~~ be support~~ed~~ ~~by~~ be required from other economic policies. In certain areas such as transport, research and technological development, and environment, the EC Treaties as amended by the Single Act have laid the foundations of Community policies which would not only enhance market efficiency but could also be employed with a view to regional development. Subject to the limits of the principle of subsidiarity, such policies would have to be expanded further in the process ~~to~~ towards economic and monetary union.

Sufficient wage flexibility and labour mobility could also help to ease regional problems and contribute to avoiding changes in competitiveness in different regions of the Community that could lead to relatively large declines in output and employment in areas with deteriorating competitiveness. In order to reduce adjustment burdens temporarily, it might be necessary in certain circumstances to organise financing flows through official channels. Such financial support would be additional to what might be provided by spontaneous capital flows or external borrowing and should be granted ~~at~~ on terms and conditions that would prompt the recipient to intensify its adjustment efforts.

33. Macro-economic developments are the third area in which action would be required. While policies to ensure a proper distributional and allocative functioning of the market without frontiers would have to be formulated and, in part, executed at the Community level, many of the developments on which macro-economic conditions depend would continue to be determined by factors and decisions operating at the national level. This would apply not only to wage negotiations and other market-determined behaviour, but in particular also to budgetary policies. Aside from a system of binding rules governing the size and the financing of national budget deficits, decisions on the level and composition of government spending and many revenue measures would remain the preserve of member states even at the final stage of economic and monetary union. Only if the decision were taken that major public goods constituting the bulk of public sector activity (internal and external security, justice, social security, environment) should to a large extent be provided at the Community level (2) would the Community budget be significantly enlarged.

However, an economic and monetary union could only operate on the basis of mutually consistent and prudent behaviour by governments, unions and other economic agents in all member countries. In particular, unco-ordinated and divergent national budgetary policies would not only undermine monetary stability, but would also generate imbalances in the real and financial sectors of the Community and render it impossible to pursue appropriate macro-economic policies for the Community as a whole. This is why all countries would have to accept that sharing a common market and a single currency area imposes narrow constraints on budgetary policies and requires strict fiscal discipline. Similarly, strong divergences in wage levels not justified by different trends in productivity would produce economic and monetary tensions.

To some extent market forces would exert a disciplinary influence because financial markets, consumers and investors would respond to differences in macro-economic developments in individual countries and regions, assess the budgetary and financial position of different countries, penalise deviations from commonly agreed fiscal guidelines or wage settlements, and thus ~~would~~ exert pressure for sounder policies. However, experience suggests that market perceptions do not necessarily provide strong and compelling signals. In particular, in the financial field, rather than leading to a gradual adaptation of borrowing costs, market views about the creditworthiness of official borrowers tend to change abruptly and result in the closure of access to market financing. The constraints imposed by market forces might either be too slow and weak or too sudden and disruptive.

For this reason an economic and monetary union would require binding arrangements which would enable the Community to monitor its overall economic situation, to assess the consistency of developments in individual countries and with regard to common objectives and to formulate guidelines for policy. This would be particularly important for budgetary policies. Such arrangements should, firstly, impose effective and binding limits on budget deficits that could be incurred by individual member countries of the Community, although in setting these limits the particular situation of each member country might have to be taken into consideration. Secondly, the arrangements would have to include (in accordance with the criteria laid down for a European System of Central Banks) strict limits - both in size and duration - on the maximum permissible access to monetary financing, as well as on borrowing in non-Community currencies. Thirdly, the arrangements should enable the Community to conduct a coherent mix of fiscal and monetary policies, i.e. to dispose of a system of rules that could be applied with a view to determining the aggregate balance on national budgetary positions, including that of the Community.

34. In <u>summary</u>, the establishment of an economic union would require:

- the creation of an internal market without physical, regulatory or fiscal frontiers, supplemented by a competition policy which effectively removes distortions in competition;
- common policies in transport, research and technological development, which would help to exploit the full potential of the single market and its role in the allocation of resources;
- a system of financial transfers to stimulate regional and structural developments through investment programmes, which would help regions with lower productivity to catch up with the more developed parts of the Community;
- a framework for monitoring and co-ordinating general macro-economic developments in the Community with a view to attaining non-inflationary, balanced economic growth;
- binding rules setting maximum possible deficits for national budgets taking into consideration the situation of each member country, and strict limits on both monetary financing and borrowing in third currencies;
- effective an binding procedures for the co-ordination of national budgetary policies which would enable the Community to determine its macro-fiscal policy stance ~~policy~~.

These requirements would not only have to be met in order to derive the greatest possible benefit from an enlarged economic space, they would also be indispensable for the cohesion of the monetary union.

4. Institutional arrangements

35. Management of the economic and monetary union therefore would call for an institutional framework which would allow policy to be decided and executed at the Community level in those economic areas that were of direct relevance for the functioning of the union. The institutional framework would have to guarantee efficient economic management, properly embedded in the democratic process. The creation of a monetary union would necessitate the setting-up of a new monetary institution, placed in the constellation of Community institutions (European Council, Council of Ministers, European Parliament, Commission and Court of Justice). The establishment of economic union would not necessarily require the creation

of a new institution, but the formulation and implementation of common policies in non-monetary fields and the co-ordination of policies under the competence of national authorities~~,~~ could require a revision and, possibly, some restructuring of existing Community institutions.

36. The need for a new monetary institution would arise because a single monetary policy could not be decided and implemented independently by different central banks and because decisions concerning day-to-day monetary policy operations would have to be centralised if they were to respond quickly to changing market conditions. For these reasons the Community's domestic and international monetary policy would have to be organised in a European System of Central Banks (ESCB). The System could consist of a central institution (with its own balance sheet) and national central banks. At the final stage the ESCB - acting through its Council - would formulate and decide the targets of monetary policy and manage the Community's exchange rate vis-à-vis third currencies. The national central banks would be entrusted with the implementation of policies in conformity with guidelines established by the Council of the ESCB and in accordance with instructions from the central institution.

The European System of Central Banks, which would embody the Community's monetary order, should rest on the following basic principles:

Status

- independence of instructions from national governments and Community authorities;
- ~~a~~ proper democratic legitimisation through reporting and appointment procedures;
- appointment of the members of the Board by the European Council on the proposal ~~by~~ of the ESCB Council; the tenure of Board members would be for five to seven years and ~~it~~ would be irrevocable;
- transmission of an annual report by the ESCB to the Council of Ministers and the European Parliament; the Chairman of the Board could be invited to report to these institutions;
- supervision of the administration of the System independently of the Community bodies, for example by a supervisory council or a committee of independent auditors;

Structure and organisation

- ~~a~~ federative structure, since this would correspond best to the political structure of the Community;
- ~~the~~ establishment of a European Central Bank Council (composed of the governors of the central banks and the members of the Board), which would be responsible for the formulation of and decision on the thrust of monetary policy;
- ~~the~~ establishment of ~~the~~ a Board (with ~~its~~ supporting staff), which would monitor monetary developments and oversee the implementation of the common monetary policy;
- national central banks, which would execute the day-to-day operations in accordance with instructions given by the Board.

Mandate and functions

- the System would 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 maintenance of a properly functioning payment system; the System would be committed to regulate the amount of money in circulation and the volume of credit supplied by banks and other financial institutions on the basis of criteria designed to ensure price stability as well as economic growth;
- the System would be responsible for the formulation of banking supervisory policy at the Community level and for co-ordination of the banking supervision policies of the national supervisory authorities.

Policy instruments

- the instruments available to the System would be specified in its statutes, together with a procedure for amending them; the instruments would comprise both regulatory powers and the authority to conduct central banking operations in money and foreign exchange markets;
- there would be strict limitations ~~of~~ on lending to all public authorities;

- the monetary policy instruments would be oriented towards a free market economy.

37. The institutional requirements for effective conduct of <u>economic policies</u> should be assessed in the light of the functions which would be performed at the Community level. As noted in the previous section, there would be four broad areas in which the Community would have to be involved: firstly, the establishment and maintenance of a single market for persons, goods, services and capital; secondly, competition policy and other measures aimed at strengthening market mechanisms; thirdly, the formulation and implementation of common policies aimed balancing the process of market integration; and fourthly, co-ordination of macro-economic policies, in particular with a view to applying a framework of binding rules which would enable the Community to enforce budgetary restraint and to avoid major differences in public sector borrowing requirements between individual member countries, to follow a common policy with regard to the financing of budget deficits and to formulate a macro-fiscal policy stance of the Community.

The necessary institutional framework for performing these four tasks is already in place with different, though partly overlapping, functions conferred on 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 economic areas in which the Community would be involved, two basic requirements would have to be fulfilled: firstly, to the extent that policies were decided and enacted at the Community level, there would have to 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 would be to co-ordinate policies, its task would have to involve the application of a system of binding rules to individual member states. By analogy with the structure of the European System of Central Banks, where the ESCB Council would determine the broad lines of monetary policy and the day-to-day execution of these policies would be in the hands of the Board, a similar allocation of responsibilities between the Council of Ministers and the Commission could be envisaged in the economic field.

In order to be able to carry out their functions within the existing institutional framework, the Community bodies would have to possess adequate instruments and means. As far as the implementation of the single market and competition policy 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 legislative, executive and judicial authority.

With regard to common policies aimed at strengthening the functioning of the single market, the foundations for a more effective Community role in regional and structural development ha~~d~~s recently been put in place, 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 would have to be further extended and made more effective.

In order to enable the Community to pursue an appropriate macro-economic policy, new procedures would have to be developed. These procedures would have to define and maintain a fair balance between co-ordination through binding rules fixing a set of objectives and constraints and discretionary co-ordination adapted to a particular economic situation. This would imply a need for both horizontal co-ordination - between member countries and the Commission and the Council - and vertical co-ordination between a member country and the Commission.

The co-ordination of macro-economic policies would ~~allow~~ make it possible to determine a strategy for growth and employment in an environment of price stability and economic cohesion. For this purpose co-ordination would involve: defining medium and short-term policy approaches, bearing in mind all their economic and social implications; setting a multi-year framework for national and Community budgetary policies; managing common policies, particularly with a view to improving economic and social cohesion; and determining, in close consultation with the ESCB Council, the Community's exchange rate policy.

The most difficult and most important task in this context would be to develop an effective procedure for joint decision-making in the field of budgetary policy. This would involve, firstly, ~~the~~ definition of the overall stance of fiscal policy, i.e. the size and the financing of the aggregate budgetary position in the Community; secondly, binding rules and collective decisions concerning budget deficits that could be incurred by individual countries; and thirdly, strict limits on the maximum permissible access to monetary financing as well as on borrowing in non-Community currencies.

While the involvement of the Community in non-monetary policies would be based on the existing institutional setting, it would be of paramount importance that the ensuing policy decisions resulted in a coherent and consistent set of measures which would clearly signal the Community's policy stance. Without an unequivocal formulation of economic policies, in particular in the budgetary field, the responsibility for macro-economic policy for the Community as a whole would fall on monetary policy. This would leave the Community with only one macro-economic policy tool and therefore significantly impede an effective policy geared to stability and growth.

38. The new Treaty laying down the programme, procedures and organs of the economic and monetary union would create a situation in which the existing Community institutions (European Council, Council of Ministers, European Parliament, Commission, and Court of Justice) would be supplemented by a new institution of comparable status, the European System of Central Banks. Relationships and interactions between these bodies would have to be defined not only in order to construct a consistent institutional framework, but also to ensure an effective procedure of consultation and co-ordination between budgetary and monetary policies. To this end appropriate ~~and regular~~ relations on a regular basis between the existing institutions and the European System of Central Banks would have to be established ~~which would~~ providing for consistent consultation procedures without, however, impinging on the policy responsibilities entrusted to each institution in its own field of economic and monetary management. An involvement of the European Parliament and national parliaments in the co-ordination process could be considered in addition to the role to be played by the Council and the Commission, and the European Parliament could be consulted in advance on the stance of economic policy in the Community. The consultation process should include a yearly joint assessment of the overall economic and monetary situation and prospects, and the formulation of a general policy guideline for the year to come. Moreover, the Council of Ministers and the Commission would submit a report each year to the European Council and the European Parliament on the functioning and the status of the economic and monetary union.

1-2

? appropriate relations and regular contacts would have to be ...

III. Steps towards economic and monetary union

1. Principles governing a step-by-step approach

cf. forward

39. 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 II 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 would need time to adapt their economic behaviour to a new setting. Similarly, it would not be possible to change the balance of powers within the Community at once in all fields. Rather, it would be necessary to build on success and to retain the possibility of correcting the course of action in the light of new experiences.

The ambition of the final objective, the present diversity in the situations of the European countries and the variety of areas involved - which go well beyond the economic and monetary sphere - make it necessary to be clear concerning the path to be mapped out.

In designing a step-by-step approach along this path the general principle of subsidiarity, referred to earlier in this Report, as well as a number of further considerations would have to be taken into account.

40. Discrete but evolutionary steps. The process of implementing economic and monetary union would have to be divided into a limited number of clearly defined stages. Each stage would have to represent a significant change with respect to the preceding one. New arrangements coming into force at the beginning of each stage would gradually develop their effects and bring about a change in economic reality so as to pave the way for the next stage. This evolutionary development would apply to both functional and institutional arrangements.

41. Parallelism. Parallel advancement in economic and monetary integration would be indispensable to avoid imbalances which could cause economic strains and loss of political support for further developing the Community into an economic and monetary union. Perfect parallelism, however, at each and every point of time would be impossible and could even

be counterproductive. Already in the past the advancement of the Community in certain areas has gone hand in hand with temporary standstill in others, thus involving only partial parallelism. A certain amount of temporary deviations from parallelism is part of the dynamic process of the Community. However, parallelism would have to be maintained in the medium term.

42. <u>Calendar</u>. The conditions for moving from stage to stage cannot be defined exactly in advance. They would depend on too many factors to permit the setting of explicit deadlines. The timing of, especially, the move to irrevocably fixed exchange rates would have to be judged in the light of circumstances by the Council, the Commission and the European System of Central Banks (ESCB), which would have been created in the second stage. A firm commitment to the final stage, as described in Part II of this Report, would however be indispensable. There should be a clear indication of the timing of the first step. It could begin [soon after the political decision to draw up a new Treaty has been taken, but at the latest] when the Directive for the full liberalisation of capital movements comes into force on 1st July 1990. [It might be envisaged that this first stage ~~will~~ would be completed with the implementation of the single market at the end of 1992.]

43. <u>Indivisibility and gradualism</u>. Gradual progress in a step-by-step approach should not produce at any point in time ambiguities about the ultimate responsibility for policy decisions and execution. Unless it is unmistakable who (i.e. whether national governments or the Community; which organ or institution) has "the last word", there would be a risk of market uncertainty and policy conflict. Policy functions are not equally divisible in all areas.

In the monetary field, once exchange rates ~~are~~ were irrevocably locked - as was pointed out in Part II of the Report - a common monetary policy would be required and would have to be formulated collectively in the framework of the European System of Central Banks. As the authority over monetary policy cannot be shared out among several autonomous decision-making bodies, the ultimate decision-making power over each Community currency would rest with the respective national central bank until exchange rates were locked. [This sets the limit of the possible attribution of policy functions to the central institution before the final stage.]

At the same time, however, if the objective of economic cohesion and the attainment of progressive exchange rate stability ~~is~~ were not to be put in jeopardy, the extent to which the national decision-making power ~~can~~ could be exercised in practice ~~will~~ would be increasingly constrained for all central banks and ~~by force of events will~~ decisions would perforce be have to take ~~place more and more~~ increasingly with in a framework of close co-operation and co-ordination. As suggested in the description of concrete steps, collaboration ~~can~~ could be greatly strengthened long before the responsibility for monetary policy ~~is~~ was actually transferred to the ESCB. Tense?

In the budgetary field policy functions can be, and are, shared between different levels of government in all constitutional systems. This facilitates a step-by-step approach to economic and monetary union.

44. 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~~ in the case of 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 participation in the same set of institutions, should be maintained, while allowing for a degree of flexibility concerning the date on which some member countries would join certain arrangements. The management of each set of arrangements should be the responsibility of those who fully participate in it.

2. The Treaty

45. The implementation of economic and monetary union would, in accordance with the new Article 102A ~~as~~ introduced into the EC Treaty [by] by virtue of? / through the Single Act, have to be embodied in a new Treaty. This Treaty would provide the legal foundation on which the institutional framework of, and concomitantly the distribution of policy responsibilities in, an economic and monetary union, as described in Part II of the Report, would be based. ? / will?

Treaty of Rome

The Committee has examined the scope for progress in ~~the~~ economic and monetary integration under the present legal provisions ~~as they are~~ in force in each member country. This investigation has shown that unless national legislations ~~were~~ are amended in various respects, ~~there~~ ~~exist.~~ will be narrow the scope ~~bounds~~ for further action on the part of national authorities: no member country is able to transfer decision-making power to a Community body, nor is it possible to set up arrangements for a binding ex ante co-ordination of policies. As a consequence, concrete steps towards economic and monetary union would have to be confined to measures strengthening co-operation, mutual surveillance, analysis of developments and non-binding co-ordination of policies until a new Treaty had been ratified.

46. One procedure would be to conclude <u>a new Treaty for each stage</u>. The advantage of this procedure would be that it would explicitly reaffirm at each stage the political consensus. Its disadvantage would be that, as well as being unwieldy and slow, the overall consistency of the process might not be sufficiently safeguarded and sight ~~may~~ might be lost of the ultimate objective. It would also carry the risk that progress in parallel between the monetary and non-monetary sides would not be respected.

47. Alternatively, it could be decided to conclude <u>a single comprehensive Treaty</u> which would formulate clearly the essential features and institutional arrangements of economic and monetary union and the steps in which it could be achieved. Such a Treaty could facilitate the implementation process through the provision of "organic laws" and enabling clauses and it could also indicate the procedures by which the decision would be taken to move from stage to stage. Each move would 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? The European Council might have to take the final decision, but what say would the organs of the economic institution and monetary institution respectively have in proposing, or giving advice on, the decision?]

3. <u>The ECU</u>

48. The Committee has examined various aspects of the <u>role of the ECU</u> in the process of economic and monetary integration in Europe. While the ECU should develop into the future single currency of the Community, the Committee felt that the future development of the ECU should be determined

relied upon? regarded as?

in the market place and by the extent to which market participants find it convenient to use the ECU for transactions. While all obstacles to its use should therefore be removed soon, the ECU should not be utilised by official authorities as the driving force of monetary union, nor should it be allowed to become a source of monetary instability.

The Committee's conclusions and proposals regarding this important subject are to be found in several parts of the is Report. They concern both the final phase and the intermediate stages of the economic and monetary union. For expositional convenience the conclusions are summarised here under in four findings propositions.

49. Firstly, the Committee considered that a <u>parallel currency approach</u> would not be a useful or a desirable way to establish a monetary union. According to this approach the ECU would become a fully-fledged currency created autonomously and in addition to national currencies. The ECU as a parallel currency would circulate alongside, and compete with, national currencies. The proponents of this approach maintain that the gradual crowding-out of national currencies by the ECU would make it possible ~~allow~~ to circumvent the institutional and economic difficulties of establishing a monetary union. The Committee rejected the parallel currency approach for two main reasons. Firstly, an additional source of money creation without a precise linkage to economic activity could jeopardise price stability. Secondly, the addition of a new currency, subject to an independent monetary policy, would further complicate the already difficult endeavour of co-ordinating different national monetary policies. In conformity with this view, the Committee does not support the abandonment of the basket definition for the ECU, or the introduction of an independent monetary policy for the ECU, or the establishment of a link between the private and the official circuits of the ECU.

50. Secondly, the Committee considered that all the <u>obstacles to the voluntary use of the ECU</u> by the private sector as a unit of account and as a means of settlement should be removed. In order to avoid undesirable distortions in the financial markets there should be no official discrimination in favour of the ECU; there should, however, be both direct and indirect encouragement. Direct encouragement could include increased borrowing in ECUs by public authorities, increased use of the ECU in

official transactions inside and, whenever possible, outside the Community, larger exchange market interventions in ECU, and greater support of the ECU clearing system. Indirect encouragement could consist of attributing to the ECU the status of a foreign or a national currency in each member country, of increasing the operations in official ECUs in the EMS and of increasing the group of ~~third~~ "other" holders.

51. Thirdly, the Committee was of the opinion that the ECU should develop into the future currency of the Community. A monetary union does not necessarily imply a single currency, but for economic, political and psychological reasons a single currency would be a natural and desirable feature of a monetary union. A declaration that the ECU should develop into the future currency of the Community is desirable. It would assure private agents that there would be no discontinuity between the present ECU and the single currency of the union and that ECU obligations would be payable at face value in ECU if the transition to the single currency had been made ~~at~~ by the time ~~of the~~ the contract matur~~ity of the contract~~ed.

52. Finally, the Committee examined the possible role of the ECU in the conduct of a common monetary policy. A proposal in this respect was that the official ECU could be used as a reserve instrument, establishing a link between each national central bank and the central institution of the European System of Central Banks. The ECU would circulate only among central banks and provide a basis for an operational framework for a common monetary policy that would replace voluntary co-ordination. The Committee felt that such a proposal was one possible way of preparing the ground for a common monetary policy in the course of the second stage.

4. Concrete steps in three stages

53. The Committee is of the view that the evolution towards economic and monetary union could be divided into three major stages. In each stage a number of concrete and parallel steps would be implemented in the institutional, economic and monetary field which would advance the process of integration, ensure the gradual construction of the institutional framework and reorganise policy responsibilities in accordance with the requirements of an economic and monetary union.

54. Both strategic considerations and actual economic developments would call for a particularly careful design of the <u>first stage</u>. Firstly, in order to impart a strong momentum to the process of economic and monetary union, and to underpin its credibility, there would have to be a clear and convincing political endorsement of the final objective reflecting the common will of Community countries. Secondly, it would have to be taken into account that the implementation of the internal single market programme currently under way and ~~would~~ significantly ~~strongly~~ affect the economic environment in the Community. In particular:

- the complete liberalisation of capital transactions by the middle of 1990 is an irreversible process in which the European countries are already engaged. There is a serious risk that in the absence of an explicit procedure to determine the overall monetary policy stance in the Community, national monetary policies will be subjected to different constraints. [In order to avoid such differences it is necessary that the central banks participating in the EMS transform monetary policy co-ordination from an ex post to an ex ante exercise at both internal and external levels;] <u>or alternatively</u> [in order to cope with these problems it is necessary that the central banks participating in the EMS significantly strengthen monetary policy co-ordination at both internal and external levels;] similarly, it will be essential to develop procedures to ensure that budgetary policies are consistent with exchange rate commitments;
- the sizable fluctuations within the international monetary system have led central banks to rely more heavily on intervention in the foreign exchange markets on a co-ordinated basis. However, such a policy inevitably has a direct influence on the implementation of domestic monetary policies in these countries. It is therefore urgently necessary ~~and urgent~~ that central banks create means for analysing such issues on a permanent and common basis. It is not only a matter of strengthening the impact of their operations, but also of maintaining the efficiency of their monetary management both at domestic and or European levels;
- the tendency of the European central banks to conduct within ~~in~~ the framework of the EMS their monetary policies in the light of ~~with regard to~~

domestic considerations in their respective countries is not necessarily conducive to fostering a monetary policy satisfactory for the Community as a whole. The creation of a common monetary think-tank for analysis and recommendations would make it possible to address this problem better. The deliberations within this monetary think-tank would in effect provide all central banks with a better basis for setting their own national approaches in a European context while preserving full decision-making autonomy.

The desirability of a clear demonstration of a common political will and the challenges of market integration would call for substantial and effective measures at the beginning of Stage I, although, as noted earlier, the scope for such measures would be limited as long as a new Treaty had not yet been ratified. For this reason it is crucial that Stage I would be introduced by the political decision to embark immediately on, and to conclude as quickly as possible, intra-governmental negotiations on a Treaty, as well as a set of concrete measures aimed at effectively enhancing policy co-operation and co-ordination.

55. The second stage could begin when the Treaty has come into force. This would involve the construction of the institutional framework of the economic and monetary union and, where envisaged, a gradual transfer of operational functions to the Community institutions. This stage would be characterised primarily by a training process leading to a collective decision-making, without ~~– however,~~ yet abandoning the ultimate responsibility for policy decisions at the national level.

56. The final stage would commence with the move to irrevocably locked exchange rate and the attribution of those monetary and economic competences to Community institutions ~~that have been~~ described in Part II of the Report. In the course of the final stage the national currencies would eventually be replaced by the ECU as the Community's sole currency.

5. <u>The principal steps in stage one</u>

57. <u>In the institutional field</u> this stage would involve the preparation and ratification of the Treaty on the economic and monetary union, with a procedure similar to the one followed for the Single European Act. The decision to draw up a Treaty would be coupled with an official announcement that the ECU should develop into the currency of the future monetary union in Europe.

58. <u>In the economic field</u> the steps would centre on the completion of the internal market programme, the reform of the Community's structural policies and efforts to strengthen the constraints on national budgetary policies. In particular, there would be action in three directions.

Firstly, there would be a complete removal of internal barriers and liberalisation of exchanges of goods, services and capital within the Community, according to the internal market programme adopted in the Single Act. The completion of the internal market would be accompanied by a strengthening of Community competition policy and of the executive and judicial authority to identify and sanction infringements of Community law.

Secondly, there would be full implementation of the "Brussels package" for reforming and doubling the structural funds, designed to enhance substantially the ability of Community policies to promote regional development and to correct economic imbalances.

Thirdly, the 1974 Council Decision on economic convergence would be replaced by a new procedure that would strengthen considerably the possibilities for constraining budgetary imbalances, as well as for assessing the consequences and its consistency of the overall policies of the Member States. Co-ordination would be based on recommendations and carried out ~~with~~ taking due account of the views of the Committee of Governors. In particular, the revised 1974 convergence Decision on would:

- set up a new procedure for budgetary policy co-ordination, with increasingly precise quantitative guidelines and medium-term orientations;
- define a programme of budgetary consolidation for member countries concerned [by reducing, where necessary, the central

government deficit to no more than X% of GNP over a period of Y years];

- establish a process of multilateral surveillance of economic developments and policies based on agreed indicators. Where performances ~~are~~ were judged inadequate or detrimental to commonly set objectives, recommendations and policy consultations would take place at the Community level with the aim of promoting the necessary corrections in national policies;
- provide for the possibility of promoting, where ~~felt~~ deemed appropriate, concerted budgetary action~~s of~~ by the member countries.

59. In the monetary field focus would be placed on implementing financial integration and intensifying co-operation and the co-ordination of monetary policies. Realignments of exchange rates would remain one of the instruments for adjustment~~ent of~~ms imbalances among Community countries, but an effort would be made by every country to make the functioning of other adjustment mechanisms more effective. Actions would develop along several lines.

Firstly, through the approval and enforcement of the necessary Community Directives, ~~full implementation would be given to~~ the objective of a single financial ~~space~~ area in which all monetary and financial instruments ~~would~~ circulate freely and banking, securities and insurance services ~~would be~~ are offered uniformly throughout the area would be implemented.

Term?

Secondly, efforts would be made to include all Community currencies in the EMS exchange rate mechanism. The same rules would apply to all the participants of the exchange rate mechanism.

Thirdly, all regulatory impediments to the voluntary use of the ECU as a common numeraire and a means of settlement by private economic agents would be removed.

Fourthly, 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 (prominence?) and making it the forerunner of the Council of the European System of Central Banks to be created under the new Treaty. The thrust of the revision would be to strengthen the co-ordination of monetary policy among all member countries of the Community. To this end, the Committee of Governors would:

- formulate recommendations on the overall orientation of monetary and exchange rate policy, as well as on measures taken in these fields by individual countries. In particular, the Committee would be consulted in advance of national decisions on the course of monetary policy, such as the setting of annual domestic monetary and credit targets. The Committee could declare publicly, in the event of speculative capital flows unwarranted by fundamentals or underlying monetary policy, that the European central banks stood ready to counteract these capital flows by interventions;
- make policy recommendations to individual governments and the Council of Ministers on non-monetary policies that could affect the internal and external monetary situation in the Community, especially the functioning of the EMS. The outcome of the Committee's deliberations could be made public by the Chairman of the Committee;
- submit an annual report on its activities and on the monetary situation of the Community to the European Parliament.

The Committee's opinions and recommendations would not have to reflect unanimity, but could be established by a qualified majority; the recommendations would not be binding. In order to reinforce the monitoring and the analysis of monetary and economic developments the Committee would:

- set up three committees (supported by a permanent research staff) which would report regularly to and advise the Committee of Governors. A monetary policy committee would define common surveillance instruments, propose harmonised objectives and instruments and help to ~~develop~~ induce gradually a ~~process~~ changeover from ex post analysis to an ex ante approach to monetary policy co-operation; a foreign exchange policy committee would monitor and analyse exchange market developments and assist in the search for effective intervention strategies; [should these two committees possibly be merged into a single one in order to facilitate an integrated approach to monetary policy?] a committee on banking supervision would ~~undertake~~ hold regular consultations on matters of common interest in this field.

[Finally, efforts would be made to increase the independence of national central banks.]

60. A number of Committee members advocated the creation of a European Reserve Fund (ERF) that would foreshadow the future European System of Central Banks. [This institution would be established in the context of a new Treaty or, alternatively, by an inter-governmental agreement among the member countries concerned.] The main objectives of the ERF would be:

- to serve as a training ground for achieving ? implementing a better co-ordination of monetary analysis and decisions;
- to facilitate, from a Community point of view, the concerted management of exchange rates and possibly to intervene visibly (in ~~third and~~ participating and/or other currencies currencies) on the foreign exchange market, ~~upon~~ at the request of the participating central banks;
- to be the symbol of the political will of the European countries and ~~therefore~~ thus to reinforce the credibility of the process towards economic and monetary union.

The resources of the Fund would be provided by ~~a~~ the pooling of a limited amount of reserves (for instance 10% at the start) by participating central banks, and the Fund would need to have ~~require~~ a permanent structure and staff in order to carry out ~~achieve~~ its tasks, viz. ~~i.e.~~:

- managing ~~management of~~ the pooled reserves;
- intervening ~~interventions~~ on the exchange markets as decided by the members;
- analysing, from a collective perspective, monetary trends with a view ~~in order~~ to enhancing ~~enhance~~ policy co-ordination.

All EC central banks would be eligible to join the Fund. However, membership would be subject to their participation in the exchange rate mechanism, the reason being that the EMS implies specific constraints on monetary policy and foreign exchange interventions, ~~that~~ both of which call for ~~require~~ a common approach on the part of the central banks concerned.

The management of the ERF would consist of:

- a Board of Directors, which would comprise ~~automatically~~, ex officio, the Governors of each central bank participating in the ERF;
- an Executive Committee, whose members would be selected by the Committee of Governors on the basis of competence. This Executive Committee would be ~~of a~~ small in size, consisting of three or four members who would have direct responsibility for the different departments of the ERF;
- ~~the~~ two Committees: a Foreign Exchange Policy Committee and a Monetary Policy Committee;
- two ~~departments~~ Departments: a Foreign Exchange and Reserves Management Department, and a Monetary Policy Department.

61. Other members of the Committee felt that the creation of an ERF was not opportune at this stage. Their reservations stem from the fact that:

- too much emphasis is placed on external considerations, ~~giving support to~~ fostering the illusion that common interventions by such a Fund could be a substitute for economic adjustment to correct imbalances within the Community or would offer individual countries more leeway in their domestic monetary policy;
- the proposal ~~involved~~ involves an institutional change which, in accordance with Article 102A of the amended EC Treaty, would fall under the procedure stipulated ~~of~~ in Article 236 and require a new Treaty; the setting-up of the Fund under the same procedures ~~that~~ as were applied to the establishment of the EMS ~~was~~ is not considered possible;
- it would be counterproductive to set up a new institution for a limited period of time, in particular if most of the functions of the Fund could be performed by ~~a strengthening of~~ the Committee of Governors if it were given wider powers;
- it would institutionalise the separation of the Community into two groups of countries.

However, the Committee members opposed to the immediate creation of the ERF could envisage some pooling of reserves and intervention operations at a later stage, but before the definite locking of parities.

6. The principal steps in stage two

62. In the institutional field the basic organs and structure of the economic and monetary union would be set up ~~built~~ in accordance with the Treaty, involving both the revision of existing institutions and the establishment of new ones. The institutional framework would gradually take over operational functions, serve as the centre for monitoring and analysing macro-economic developments and promote a process of common decision-making, although the ultimate policy responsibility would still remain in the hands of the national authorities.

63. In the economic field the Council of Ministers, deciding by a ~~with~~ qualified majority, and the Commission [with some involvement of the European Parliament?] would assume a greater role in promoting the convergence and co-ordination of economic policy in the Community. To allow the determination of a common budgetary stance a certain number of steps would be taken.

Firstly, progressively more precise rules relating to the size of the budget deficits and their financing would be introduced.

Secondly, medium-term guidelines for key financial targets and economic programmes would be adopted in the member states. Moreover, budgetary objectives would be established jointly, when deemed ~~felt~~ appropriate, as part of a co-ordinated budgetary and economic policy.

Thirdly, resources for supporting the structural policies of the member states would be enlarged and the Community investment programmes in the fields of research and infrastructures strengthened.

[Finally, a view would be taken on the exchange rate vis-à-vis major third currencies and other international monetary matters.]

64. In the monetary field the European System of Central Banks - having all the principal features described in Part II of this ~~the~~ Report - would be set up and would absorb the previously existing institutional monetary arrangements (the EMCF, the Committee of Governors, the committees for monetary policy analysis, foreign exchange policy and banking supervision, and the permanent Secretariat). The most important feature of this stage would be ~~is~~ that the functions of the ESCB in the formulation and implementation ~~operations~~ of a common monetary policy would gradually evolve as experience was ~~is~~ gained. Exchange

rate realignments would remain an instrument of adjustment, but there would be an understanding that the frequency and the extent of realignments should be steadily continuously reduced.

Initially the ESCB framework would be used: (a) as a joint facility ~~which~~ to be shared by national central banks ~~would share in~~ for implementing national monetary policy through operations in domestic and foreign exchange markets; (b) as a centre for monitoring and analysing domestic monetary conditions and foreign exchange market developments; and (c) as a centre for the co-ordination of national monetary policies. In the course of this stage the procedures would be altered in such a way as to capture the entire monetary operations of national central banks in their accounts and their transactions with the ESCB.

In addition, a certain number of actions would be taken in stage two.

Firstly, a certain amount of exchange reserves would be pooled and would be used to conduct limited exchange market interventions in accordance with guidelines established by the ESCB Council.

Secondly, general monetary targets would be set for the Community as a whole, with a presumption that national monetary policy would be executed in accordance with these global guidelines.

Thirdly, while the ultimate responsibility for monetary policy decisions would remain in the hands of national authorities, the operational framework necessary for deciding and implementing a common monetary policy would be created and experimented with. In this context ECUs issued by the ESCB could be used as reserve instruments.

Fourthly, regulatory functions would be exerted by the ESCB in the monetary and banking field in order to achieve a minimum harmonisation of provisions (such as reserve requirements or payments arrangements) ~~that are~~ necessary ~~to~~ for the future conduct of a common monetary policy.

Fifthly, the margins of fluctuation~~s~~ ~~with~~ in the ERM would be narrowed ~~in order to approach~~ as a move towards the final stage of the monetary union, in which they ~~will~~ would be reduced to zero.

[Still to be discussed: voting procedure in the ESCB Council in stage ~~II~~ two.]

7. <u>The principal steps in stage three</u>

65. <u>In the institutional field</u> there would be the full attribution of competences to Community institutions, as foreseen in the Treaty.

66. <u>In the economic field</u> the Council of Ministers and the Commission [in co-operation with the European Parliament] would have the authority to take directly enforceable decisions, i.e.:

- to impose constraints on national budgets to the extent to which this ~~is~~ was necessary to prevent imbalances that ~~may~~ might threaten monetary stability;
- to make discretionary changes (through a procedure to be defined) in Community resources to supplement structural transfers to ~~M~~member ~~S~~states or to influence the overall policy stance in the Community;
- to propose discretionary changes (through a procedure to be defined) in the level of harmonised taxation rates;

is this a "directly enforceable decision"?

- to apply some form of conditionality to existing Community structural policies and to Community loans (as a substitute for the present medium-term loans facility);
- to decide on exchange rate policy.

67. <u>In the monetary field</u> the irrevocable locking of exchange rates would come into effect and the ESCB would ~~fully~~ assume all its responsibilities as foreseen in the Treaty and described in Part II. In particular:

- concurrent with the announcement of the irrevocable fixing of parities between the Community currencies, the full responsibility for the formulation and implementation of monetary policy in the Community would be attributed to the ESCB Council;
- decisions on exchange market interventions in third currencies would be made entirely under the responsibility of the ESCB Council in accordance with Community exchange rate policy; the execution of interventions would be entrusted to [one or ?] national central bank[s];

- work would be carried out on technical and regulatory arrangements ~~work would be done to prepare~~ for the transition to the ECU as single currency of the Community.