15th November 1988

To: M. Lamfalussy

From: Gunter D. Baer

Please find attached for your information a copy of our first attempt to draft a skeleton of the Report of the Delors Group. This draft has been discussed yesterday with M. Delors and it was agreed to make the following changes (most of which we hope to have introduced into the draft by Friday):

Part I 2: a revised section dealing with the issues relating to fiscal policy;

3: a reorganisation, stressing that full monetary union will imply a single currency and that the macro-economic requirements stated in the Werner Report represent an intermediate, though the most substantial, step;

4: a clearer description of the organisational structure of the European system of central banks and a more explicit description of the objectives of the centre for economic policy decisions.

Part III 2: A more detailed section on the ECU, contrasting two alternative hypotheses: the first one is maintaining the ECU in its present basket definition, removing all possible obstacles to its use and eventually giving legal tender status to the ECU throughout the Community; the alternative hypothesis is to change the definition of the ECU and introduce it as an additional currency managed by the centre of the European system of central banks;

3: reorganise the steps:

Step 1: in line with Pöhl's proposal, largely as outlined in the present draft;

Step 2: closer to the de Larosière proposal, emphasising that the rational for it lies in the agreement (manifested in the treaty) to proceed to economic and monetary union;

Step 3: implementation of most of the features of economic and monetary union;

Final step: move to a single currency.

We will also try to say a bit more about exchange rate policy and management and, as wished by M. Delors, suppress all references to a transfer of power from the national to the Community level.

Delors

Skeleton of the Report

Outline

Part I The final stage of economic and monetary union

1. Introduction
2. The principal features of economic union
3. The principal features of monetary union
4. Institutional arrangements in the economic and monetary union
5. How to proceed?

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

(to be drafted)

Part III Proceeding by steps

1. Principles
2. The main strands of action
3. Three steps

Skeleton of Report

11th November 1988

Draft

I. The final stage of economic and monetary union

1. Introduction

The establishment of an economic and monetary union will represent the final stage in the progressive process of economic integration in Europe. With the completion of this ultimate objective, the Community will form an area in which all residents can engage freely and without impediment in any kind of economic activity, subject only to commonly applied or mutually recognised rules and regulations and economic policies geared towards price stability, balanced growth and converging standards of living, high employment and external equilibrium. To an important extent these policies will be formulated and carried out at the Community level, following transfers of responsibility from national authorities to Community institutions. This shift of decision-making power, while confined to what is necessary for an efficient economic management of the Community, will manifest a surrender of sovereignty and an act of fundamental political significance. The will to do so will be reflected in the treaty that establishes economic and monetary union in the Community.

Economic and monetary union thus means that the Community is transformed from a set of independent - though interdependent - national economies into a single economy, with the same basic features that circumscribe the existing national economies: a single currency area, a single market and an institutional framework for economic policy management. At the same time, however, an economic and monetary union in Europe will differ fundamentally from existing economies in one important respect: made up of independent, historically grown nations with different levels of economic development and differing traditions, social customs and languages, the Community will remain much more heterogeneous than any of its constituent economies. It is precisely this difference which does not allow simply to model Europe's economic and monetary union on any of the

existing economies but makes it necessary to develop an innovative and unique solution.

In its search for this solution and its progressive implementation, the Committee is of the view that any step-by-step approach to the final objective can be set out only if there is a clear understanding of the meaning of economic and monetary union, its implications for economic working and decision-making and the principal elements that had to be in place for its successful and durable functioning. Economic union and monetary union form two integral parts of a single entity and it is only for reasons of expositional clarity that in the following sections a distinction is drawn between them.

2. The principal features of economic union

The creation of an economic union in the Community (in combination with the establishment of a monetary union) requires arrangements in three different areas of non-monetary policy.

First of all, as already pointed out in the 1970 Werner Report, an economic union implies the realisation of a single market within which persons, goods, services and capital can move freely and without distortion of competition. The creation of this market presupposes a "level playing field" for all residents of the Community, which allows them to make decisions on production, investment and consumption in broadly similar conditions and on the basis of similar levels of information. To this end all barriers which tend to separate markets along national borders have to be eliminated. This implies in particular that all technical and regulatory obstacles are removed, standards are harmonised or mutually recognised and that tax treatment does not discriminate economic activities across Community countries. These aims can only be realised if the authority over competition and industrial policies is transferred effectively to the Community, thereby ensuring a collective decision-making about - and a uniform application of - the appropriate standards and regulations. Given that certain aspects of social policy, as well as of consumer and environmental protection, can influence significantly competitive conditions, certain minimum standards in these fields also have to be laid down at the Community level. Finally, a single market requires that all forms of taxation affecting the flow of goods and services do not provide

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differing incentives to economic activity in individual member countries - unless such incentives are deliberately part of the Community's regional or structural policies.

The establishment of the single market in conjunction with a monetary union has important implications for the working and the management of the economy of the Community. Most importantly, as adjustment of economic imbalances among member countries can no longer be supported by exchange rate realignments (which, as discussed in the next section, are ruled out in a monetary union), alternative mechanisms have to take over the role of eliminating disequilibria. While the removal of obstacles to the free flow of persons, goods, services and capital will certainly reinforce self-regulatory market forces, additional measures aimed at enhancing the effectiveness of market mechanisms are needed in order to cope with imbalances that could emanate from excessive wage claims in one member country or from external shocks with differing repercussions on individual economies. Complementary action is therefore required to increase wage and price flexibility, ensure wage setting procedures based on productivity developments and strengthen the regional and occupational mobility of labour. [Reference to income policies?]

Secondly, the single market may tend to aggravate the differences between Community countries with higher and lower levels of economic developments and could possibly produce economically and politically undesirable dislocations of industries and labour forces. The Community will therefore require adequate arrangements to address the problem of structural differences between member countries and the concomitant disparities in levels of per capita income. Without adequate safeguards in this area market forces would - at least in the short run - exacerbate rather than mitigate the differences between poorer and richer member countries and lead to intolerable strains and frictions in the Community. For this reason an economic union must possess a system of financial transfers designed to both tempering existing inequalities of standards of living and actively promoting structural development in countries with low per capita incomes. The effectiveness of such a system is partly a question of its endowment with financial resources, but also of its ability to implement effective programmes for the improvement of the productive capacity through investment in such areas as physical infrastructure, communication and education.

Thirdly, in an environment of a free market and a monetary union there is a serious danger that unco-ordinated national budgetary policies generate intra-Community imbalances, undermine monetary policy and render it difficult, if not impossible, to pursue macro-economic policies for the Community as a whole. An economic union will therefore be incomplete without functional and institutional arrangements that allow a close and flexible co-ordination of national budgetary policies - at least, as long as the Community's budget has not reached a critical size. The aim of this co-ordination is twofold. Firstly, it must help to avoid those differences between member countries' budgetary positions which could produce disturbances in real economy of the Community or in its financial market. To this end, as a minimum, national authorities have to accept limitations on foreign borrowing (outside the Community) as well as on monetary financing of budget deficits. Whether additional formal constraints are needed depends to a significant extent on the disciplinary pressure that financial markets impose on the budgetary behaviour of public authorities. The greater such market constraints the lesser is the need for binding rules on individual countries' scope for budget deficits [a more detailed and explicit discussion has to follow]. The second reason why national budgetary policies need to be co-ordinated is to enable the Community to formulate an appropriate macro-economic policy mix. ...

[Section on social dimension?]

In summary, an economic union implies the establishment of a common unrestricted market in the Community. The necessary removal of all types of barriers separating national economies will raise significantly the potential for growth and improved standards of living for all residents of the Community, but it also entails risks arising from unbalanced economic structures and the continued pursuit of national budgetary policies. For this reason an economic union also requires agreement among its member countries to set up a system of financial transfers and to accept constraints on national budgetary policy.

3. The principal features of monetary union

A monetary union implies the creation of a single currency area, i.e. an area in which one currency [or different national currencies] serves as a means of payment, unit of account and a stable store of value

for all residents of that area. A single currency area is attained when interest rates on comparable financial instruments are virtually identical [irrespective of the fact in which of the circulating currencies the instrument is denominated] and when differences between prices of tradable goods have practically disappeared.

The conditions of a single currency area are, by definition, fulfilled if there is only one currency in circulation which has taken the place of different national currencies [when can this be the case? What are the features of the single currency? Is it the ECU or one of the national currencies?].

It is also conceivable that the conditions of a single currency area can be met without the complete disappearance of national currencies. Co-existence of national currencies is, however, compatible with the concept of monetary union only if each of the freely circulating currencies has lost its particular "identity", in the sense that in the eyes of market participants all currencies are of equal quality and standing. Only then will all currencies be perfectly substitutable, i.e. they simply represent different denominations of "the same" currency of the union [but what is that currency? An additional one? The ECU?], are interchangeable without costs and are used and accepted in transactions throughout the union in the same way that different bills of a currency are used and accepted in a national economy.

Perfect substitutability between different currencies is not easy to achieve and depends critically on the realisation of a number of macro and micro-economic requirements. The essential macro-economic measures encompass, as already mentioned in the 1970 Werner Report:

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

While indispensable elements of a monetary union these requirements alone do not necessarily ensure perfect substitutability between all currencies in the Community. For example, the continuing existence of national currencies - even if intended for purely symbolic

reasons - could cast doubt on the member countries' commitment to unchangeable exchange rate parities and thus engender divergent assessments of individual currencies in the market place. Furthermore, even if fluctuating margins have been abolished, the exchange of one currency for another entails costs for commercial banks and could give rise to bid/offer spreads. For both reasons interest rate differentials between the currencies of the monetary union might not disappear. The evolution of perfectly substitutable currencies can to some extent be encouraged by official action allowing all currencies to fulfil simultaneously the traditional functions of money throughout the Community. Such measures include the recognition of legal tender status of each currency in each of the member countries of the Community and the provision that banks exchange different national currencies without different buying and selling rates. Ultimately, however, the attainment of perfect substitutability of national currencies can only be the outcome of an evolutionary market process, a basic element of which is that the macro-economic requirements of monetary union have gained full and permanent credibility in the eyes of market participants.

[What are the advantages of co-existing national currencies? How can the system operate? What are the institutional consequences?]

Monetary union will affect profoundly economic performance in the Community and will have far-reaching consequences for the management of its monetary policy. As far as economic performance is concerned the most important influences of a single currency area are that it facilitates greatly the trade and financial transactions among Community residents but that, at the same time, it renders the adjustment of economic imbalances between different member countries more difficult. Both the positive and the negative effects result essentially from the permanent fixing of exchange rates. A first advantage is that exchange rate uncertainties are eliminated and that the costs of transactions between residents of different countries of the Community are lowered, thereby imparting stimulatory effects to trade and growth. In the same vein, movements of exchange rates unwarranted by fundamental factors can no longer be a source of macro-economic disturbances and competitive distortions. The locking of exchange rates in combination with an unrestricted single market also means that trade between residents of different countries of the Community represents a domestic (and not an external) transaction - with the result

that the Community as a whole will be much less open and less susceptible to external shocks than any of its member countries. Finally, if it is firmly believed that exchange rates are permanently fixed, market participants in all countries are likely to behave more conformably and thereby contribute to the evolution of a more homogeneous economic structure in the Community.

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

As far as the consequences for monetary policy are concerned, the most significant implication is that in a system of fixed exchange rates and freely circulating identical currencies, there is no scope for independent national monetary policies. Any attempt to pursue such a national policy would destroy the foundations of the monetary union. The final objective can therefore be realised only if the Community countries consent to having <u>one</u> monetary policy and, by implication, <u>one</u> exchange rate policy vis-à-vis non-Community currencies. This implies that all member countries agree on the objectives of monetary policy, applicable to the Community as a whole.

In summary, the realisation of a monetary union means that the Community has in effect adopted one money (even if national currencies continue to circulate next to each other). This single currency area will require one monetary policy. ...

4. <u>Institutional arrangements in the economic and monetary union</u>

The management of the economic and monetary union demands an institutional framework which allows an efficient and democratic decision-making in those economic areas that are of direct concern to all

member countries of the Community. The realisation of economic and monetary union, therefore, requires the establishment of decision-making centres which, to the extent necessary, take over functions previously performed by national institutions.

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

The need for a new monetary institution arises because <u>one</u> monetary policy cannot be decided and implemented independently by different central banks and because decisions over day-to-day operations of monetary policy must be centralised in order to be able to respond quickly to changing market conditions. For these reasons both the conduct of the Community's domestic monetary policy and the implementation of the Community's international monetary policies must be organised in a <u>European central banking system</u>. The system should consist of a centre responsible for the co-ordination of short-term action (such as adjustment of interest rates and other policy instruments) and the formulation of the thrust of monetary policy in the medium-term [and the management of the exchange rate vis-à-vis third currencies], and national central banks entrusted with the execution of policies in accordance with guidelines established by the centre.

[The Committee is firmly of the view] that the European central banking system, which embodies the Community's monetary order, must be built on the following basic principles. Firstly, the mandate of the system must be to maintain the stability of money as the prime objective of the Community's monetary policy. While fulfilling this task, the system has to support the general economic policy of the Community. Domestic stability of the value of money must take precedence over exchange rate stability. Secondly, in order to be able to pursue a monetary policy aimed at price stability, but also as a consequence of the federal structure of the Community, the system must be independent of instructions from national governments and Community authorities. Thirdly, the system must reflect the

federal structure of the Community. This implies an organisation [perhaps similar to the US Federal Reserve System] which, through appropriate representation and weighted voting procedures in governing bodies, ensures that the interests of all national central banks are adequately taken into account. To this end the organisational structure of the system consists of a Board [- composition, terms of office, nominated at the European level? -] responsible for the day-to-day management, a European Open Market Committee [- which includes the Board members and national central bank governors, participation in meetings without voting rights of representatives of the Commission, Council? -] acting as the central policy-making forum [and a separate staff of the centre?] [role of the Committee of Governors? of the Monetary Committee?]. Fourthly, strict limitations must be imposed on the system's capacity to grant directly (or indirectly via national central banks) credit to public authorities, including Community authorities, in order to safeguard the system's ability to conduct an independent monetary policy geared towards price stability. Fifthly, the monetary policy instruments of the system must be aligned in such a way as to enable a monetary management without recourse to quantitative controls or other forms of direct intervention in the functioning of the financial markets. Finally, banking supervision should be integrated into the system, at least to the extent that the system could take part in the establishment of general regulations in the field of banking supervision. Moreover, the system should be involved in day-to-day supervisory activities.

Although adherence to these principles largely frees the European central bank system of political influences, it should nonetheless be accountable for its actions and policies. [How? Does the formulation of the mandate suffice? Should there be regular reporting? On What? To Whom? Council of Ministers? Monetary Affairs Committee of the European Parliament?]

The need for a <u>centre for economic policy decisions</u> in the Community derives from a number of different considerations: firstly, a common unrestricted market demands broadly uniform rules and regulations which can be decided, implemented and enforced effectively only at the Community level. Secondly, regional and structural policies across national borders of member countries must be decided collectively, with financial flows being channelled through the Community's budget. Thirdly, in

accordance with the federal structure of the Community budgetary policies will remain predominantly a preserve of national authorities; the Community budget consequently will account only for minor shares of overall revenue flows and public spending. Given the potential impact of national budgetary policies on the real economy and the financial markets of the Community, and given also the necessity to design a macro-economic policy for the Community as a whole, there is a clear need for institutional arrangements which permit an effective co-ordination of national budgetary policies.

The diversity of non-monetary policies in which the Community needs to be involved to varying degrees must be reflected in the institutional structure of the centre for economic policy decisions. It does not require a new institution but rather a reinforcement of, and adequate amendment to, the existing arrangements through which the Community can shape economic policies.

The procedures and arrangements for the implementation of a single market for persons, goods, services and capital have been laid down in the Treaty of Rome and the Single Act, conferring upon the Community the executive and judiciary authority to put the internal market programme into operation. ... [Any need for additional institutional measures?]

The foundations for a more effective Community role in regional and structural policies have been put in place under the programme for doubling the resources of structural funds by 1992. ... [Any need for additional institutional measures?]

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

5. How to proceed?

As the implementation of economic and monetary union inevitably involves a transfer of national authority over economic and monetary policies to the Community level, it must, in accordance with Section 236 of the Treaty of Rome, be embedded in a new treaty. While the legal requirements for the transfer of policy responsibilities to the Community can be established in a relatively short period, the realisation of full economic and monetary union will need much more time and can in practice be achieved only in stages and through interaction between market forces and official action. Two alternative routes to economic and monetary union are conceivable.

The first alternative is to conclude a new treaty each time a political consensus to advance one step has been reached. This procedure has the advantage of safeguarding national interests, clearly laying open at each step the political commitment to European integration and offering a high degree of flexibility and scope for pragmatic headway. At the same time, however, this approach is not only rather unwieldy and bound to be slow, it also carries the risk that with focus on pragmatic considerations sight is lot of the ultimate objective. Moreover, while there is no doubt that upon completion of the process of integration all countries will benefit greatly from economic and monetary union, each time a decision on a new step is to be made without a firm view of the ultimate goal, short-term cost considerations may be weighed against uncertain longer-term benefits and thus hamper the process of integration.

For these reasons preference should be given to a second alternative, i.e. concluding a comprehensive single new treaty which formulates clearly and in detail the features and institutional arrangements of economic and monetary union as described in the preceding sections. This procedure clearly has a number of advantages. The ratification of the treaty represents by itself an important first step, demonstrating strongly the political will to attain economic and monetary union. The treaty will then serve as a visible landmark on the way to integration against which the consistency and conformity of each individual step with the final objective can be checked. The treaty will also facilitate the implementation process through enabling clauses which, if such clauses can be activated only on the basis of unanimous agreement,

will safeguard fully the interests of each member country. Moreover, this procedure will allow all member countries of the Community to express their agreement with the final objective of European integration while, at the same time, it will not necessitate that each step is simultaneously carried out by all countries, thus leaving room for longer transition periods for countries not yet in the position to take the step.

PART III

PROCEEDING BY STEPS

1. Principles

The request made by the European Council to the Committee to study "concrete steps" reflects the fact that an economic and monetary union, as outlined in Part I, is too profound a change in the economic and institutional structure of the Community to be realized in one stroke. Households, corporations, unions, and public administrations need time to adapt economic behaviour to a new setting. Similarly, the attribution of new competences to the Community cannot be made at once in all fields. It is necessary to build on success and to retain the possibility for correcting the course of action on the basis of experience.

The process will have to be divided into a limited number of clearly defined stages. Each stage should represent a significant change with respect to the preceding one. It is expected that the new arrangements coming into force at the beginning of each stage would develop their effects over time, bringing about a change in economic reality such that the time for the next stage becomes gradually ripe.

In designing a step-by-step approach to economic and monetary union a number of considerations have to be taken into account.

A first consideration concerns gradualism and indivisibility. While the arguments above point to the need for gradualism, it has to be recognised that policy decisions and operational responsibilities are, in many specific areas, not divisible, i.e. they cannot be transferred "piece by piece" but require a quantum jump. Unless it is clearly indicated who (i.e. whether national Governments or the Community; which organ or institution) has "the last word", policy conflicts will inevitably arise. As a consequence, the effectiveness in pursuing common goals will be undermined and the benefits sought through the economic and monetary union will be lost. It will be necessary to identify meaningful "blocs" of economic and policy competences and to link one to the other in such a way as to satisfy the need for gradualism while not trying to split what is indivisible.

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A second and related consideration concerns parallelism and balanced advancement. Parallel advancement in many interrelated areas is a condition to avoid imbalances that could cause economic disruptions and loss of political support for the continuing process of developing the Community up to an economic and monetary union. Perfect parallelism, however, at each and every point of time is impossible and could even be counterproductive. Examples of this combination of partial parallelism in the development of the Community are: the shift of certain competences and not others (e.g. VAT as the common scheme for indirect taxation, with rates setting left to national governments), or progress in certain areas (e.g. the custom union) faster than in others (like the harmonization of legislation), etc. Advancement in one area may trigger advancement in others. The EMS has contributed to a greater economic convergence that has favoured capital market liberalization and the programme for completing the internal market. A certain amount of temporary deviations from parallelism may be part of the dynamic process of the Community. Parallelism has to be maintained in the medium

term.

A third consideration concerns <u>participation</u>. There is one Community, but not all the members participate fully in all its aspects from the beginning. So far this has mainly be the consequence of successive enlargements and, for the EMS, of the decision of some countries not to join the exchange rate agreement in 1979. A common adesion to the final objectives of the Community and a unitary acceptance of the same "rule of law" and participation in the same set of institutions should be preserved, while allowing for a degree of flexibility in the timing in which certain arrangements will be entered by some member states. The management of each set of arrangements should be the responsibility of those who fully participate in it.

A fourth consideration concerns the <u>calendar</u> and the timing. The announcement of an exact deadline in the Werner report in 1970 has not been confirmed by the facts. The Committee considers that the conditions for reaching the final stage are too difficult and depend on too many factors to permit a firm announcement of an explicit deadline. It has also to be considered that each stage contains a programme of legislative actions that take time, as well as the need to test the arrangements established at the beginning of the stage. Moreover, the "final stage" is not necessarily one beyond which the system will have no further evolution. Rather, it has to be seen as one in which the fundamental requirements of the definition of an economic and monetary union have been fulfilled, albeit in a setting that may be subject to changes and improvements. Thus a flexibility in the calendar is necessary. A clear commitment to the final stage as described in Part I, however, is indispensable, as well as the indication of the timing of at last the first step.

Taking into account these considerations the Committee has formulated some principles that could be retained in designing a process by steps. Such principles are the following:

- after a first step based on the existing Treaty, a new treaty will be stipulated on the basis of Article 236 of the Treaty of Rome, such that it would provide a legal basis for all the actions and developments that are required to reach the final stage of the economic and monetary union. Given the choice made for a gradualistic approach, many clauses of the Treaty will come into force only at a later stage. This approach has been followed in the past by the Community, and appears to be apt to establish the process on firm ground and to give it the necessary credibility;

- the organs of the economic and monetary union would be established when the new treaty comes into force, with all the institutional safeguards and organizational features that are deemed necessary. Initially, their competences would be modest. Over time, additional competences would be attributed to such institutions. The container would be created at the outset, the content would be poured in gradually;

- the Treaty will indicate the procedures whereby the decision will be taken to move from one stage to the next. On the one hand the subscription to the treaty will represent a single political decision embracing the whole enterprise and committing to it. On the other hand every passage from one stage to the next will require an appraisal of the situation and a political agreement. [Unanimity has been suggested by some members of the Committee. Is it to be adopted as the rule for all the stages? Who should participate in the decision? Another

aspect of this decision-making process will concern the indication of the body, or bodies, that will take the decision. The European Council may have to take the final decision, but what say will have the organs of the Economic institution and Monetary institution respectively in proposing, or giving advice about, this decision?]

- the steps should be designed in such a way as to preserve continuing adherence to the objective and policy priorities (balanced growth with price stability) throughout the implementation of the process.

2. The main strands of action

The content of an economic and monetary union as described in the first Part of this Report is manifold. Each of the two broad components of the union, economic and monetary respectively, can be furher subdivided in a certain number of areas for which the Committee has examined the main developments. In certain areas the conditions required for an economic and monetary union are the results of a continuous action to be developed in the legislative and executive sphere. In other areas such conditions can only be created through quantum jumps.

Before considering how the movement towards an economic and monetary union could be divided into a few discreet steps, it may be useful to describe what the main strands of action could be.

2.1 Moving to the Economic union.

Three sets of arrangements are necessary for an economic union to meet minimal requirements:

i) arrangements ensuring effective freedom of movement for goods, persons, services and capital. To this end the Community needs: appropriate legislation to dismantle all technical and regulatory impediments; minimum harmonization of standards and tax treatment; adequate executive and judiciary authority to identify and sanction infringements of the Community law. The procedures and institutions that are necessary to reach this objective are already in place on the basis of the Treaty of Rome and the Single Act. The programme to complete the internal market by 1992 essentially covers this part of the economic union. To fulfill this programme on schedule, however, the Community has still to accomplish a heavy legislative task, which covers such controversial areas as the harmonization of indirect taxation. Moreover, to overcome a potentially serious problem of non-compliance with the growing body of Community legislation that supports the integrated internal market, it is necessary to increase the effectiveness of the process whereby the Community law is enforced;

ii) arrangements to foster economic adjustment in conditions in which exchange rate changes will disappear. To the maximun possible extent adjustment should occur by way of market mechanisms. A first direction of policy, therefore, should aim at making such mechanisms more effective. In the business sector this may require a stronger competition policy. In the labour market this would require promoting flexibility of wages and differentiated trends in labour costs according to the differences in productivity of the various regions of the Community. However, even improved market mechanisms will not be sufficient to bring about adjustment and therefore a second direction of policies will be necessary to supplement them. Such policies require financial resources, but

have also an important qualitative dimension that may, if properly designed, significantly enhance the effectiveness of any given amount of funds made available through the Community budget. The program of doubling the resources of structural funds to 13 billion ECUs per year by 1992, coupled with the reorganization of Community structural policies, significantly improves the capacity of the Community to deal with these problems. However, the Committee considers that in a more advanced stage of the process such mechanisms should be extended further and made more effective. [The Committee may wish to indicate, in this section of the Report, how this should be done, in both quantitative and qualitative terms; this could be done by drawing material from a document that is in preparation under a request by the Committee];

iii) constraints on national budgetary policies. In this area, progress towards the economic and monetary union should follow two directions. In the first place, it should strengthen the safeguards against fiscal imbalances that may jeopardize monetary stability in the union. Such safeguards should include from an early stage limits to the external (i.e. in foreign currencies) borrowing and to the direct or indirect monetary financing of national deficits. At a later stage they should also consider the introduction of binding rules limiting the size of (current) fiscal deficits relative to GDP, on a cyclically adjusted basis. In the second place, constraints on national budgets are necessary to put the Community in the position to conduct its own fiscal-monetary mix before the Community budget reaches a size sufficient to exert a significant macro-economic influence. For both these reasons the Council Decision on economic convergence of 1974 will have to be reviewed and made more effective. [This section could be completed with specific ideas concerning the revision of the 1974

Decision].

[On points ii) and iii): Should the Report put forward the idea of a "European Fiscal System"? Such proposal would outline the principles of a comprehensive set of fiscal arrangements concerning both national and Community budgets and covering such matters as deficits, deficit financing, essential tax harmonization, respective roles of national and Community budgets, "own resources" of the Community budget, etc.]

2.2 Moving to the monetary union

The monetary union will be the result of progress accomplished in the various areas that are comprised in the definition of monetary union discussed in Part I of this Report: convertibility of currencies, irrevocable locking of parities, legal and market arrangements ensuring perfect substitutability of currencies, liberalization of capital transactions, integration of banking and financial markets, one monetary policy, move from many national currencies to a single currency. For each of these fields, the evolution leading to a monetary union needs to be briefly described.

i) irrevocable locking of parities. In dealing with the final stage of the monetary union, Part I of this Report has described the operational features of a system based on parities irrevocably fixed by construction. Moving to such final stage from the present "fixed but adjustable" regime of the EMS involves two kinds of arrangements. Firstly, a reformulation of the exchange rate agreement, that could consist in narrowing the existing margins and in a modification of the procedures for realignments. Indeed greater fixity in exchange rates should result as much from reducing the frequency and size of realignments

as from narrowing the permitted margins of fluctuation. However, to devise a "rule" that would make realignments less frequent and smaller in size is difficult. [The Committee may wish to take a position on this point.] Secondly, and more importantly, the steps should lead to a common "domestic" monetary policy, i.e. to a single decision-making process whereby money and credit of the Community as a whole are managed in common, with the aim of providing price stability throughout the Community. The crucial problem, here, is that the movement from many national monetary policies to one common policy is hardly divisible in steps. A stepwise approach may even entail the risk of conflicts of responsibilities, uncertainty for the market and overall loss of credibility for a stability oriented monetary policy. The consequence could be to lose the national anchor for price stability before a Community anchor is firmly established. [The Committee will give guidance about the message of this crucial part of the Report. If the view were that the change to a single monetary policy can only be made in one step, the problems would be: firstly, preparing this step, for instance by improving and deepening the process of ex ante consultation; secondly, suggesting criteria for deciding when this step should be taken].

ii) irreversible convertibility of currencies and legislation concerning the currency. The convertibility of currencies is now fully established in Community countries. The Committee, however, considers that this should be firmly established in the Community law. In a related field legislation concerning currency arrangements (e.g. clauses of indexation, status of legal tender, etc.) should be adopted;

iii) the evolution of the ECU. [Part I of the Report will take a position on the single currency vs. national

currencies issue. Future debates will also clarify the Committees position concerning the role of the ECU and, more generally, the hypothesis of a parallel currency. This section on the ECU will be drafted depending on the outcome of these debates.]

iv) liberalization of capital transactions: The coming into force, on July 1st 1990, of the directive on the liberalization of short-term capital movements would complete the process of liberalization of capital transactions. However, the problem of achieving the minimum harmonization in the tax treatment of capital revenues is still unresolved. [The Commission will present proposals before the end of 1988. In its report the Committee may want both to stress the importance of such harmonization and perhaps express its views about the proposals put forward by the Commission];

v) full integration of banking and financial markets. This should be achieved by the end of 1992, as part of the program of completing the internal market. The necessary directives are in the process of being prepared by the Commission or have already been presented and are being discussed before the Council. Complex technical issues remain to be solved, as well as the problems of reconciling different financial structures and traditions. In addition to what is being prepared, the monetary union will require a function of prudential supervision exerted at the Community level, at least in the banking field, which is closest to monetary policy. The Monetary institution to be created in order to operate the monetary union would have to exert such functions, while preserving the maximum degree of decentralization compatible with the union.

This description of evolutionary lines for the

various areas of a monetary union doesn't do full justice to the strong interconnections between the areas, nor to the need for "horizontal" consistency between the situations reached on each of these several fronts. The most important of such interconnections concerns the three areas of banking services, mobility of short-term capital and monetary policy (including exchange rate management). In a situation in which every bank of the Community will be free to offer deposits and loans in every currency, to every households or firm of every country, and in which - correspondingly - every households or firm will be free to hold deposits with any bank and in any currency of the Community, the conduct of monetary policy at the national level in the traditional fashion will become extremely difficult if not impossible, because national monetary authorities will have lost the large degree of territorial coincidence between their area of jurisdiction, the area in which their currency is used, and the area in which "their" banking system is operating. The steps will have to be devised taking carefully into account these interdependencies.

2.3 Evolution of the institutional setting.

... [should there be a sub-section on this subject?] ...

3. Three steps

[cette partie est très provisoire]

What follows is an hypothesis of moving to the economic and monetary union in three steps. (Such an hypothesis has been formulated on the basis of the discussions that the Committee has had thus far.)

a) Step one:

In the institutional field:

- preparation and ratification of the Treaty on the Economic and Monetary Union.

In the economic field:

- significant advancement in the internal market programme as planned in the Single Act;
- significant advancement in the implementation of the "Brussels package" of doubling the structural funds and ....[to be completed]....;
- replacement of the 1974 Council Decision on economic convergence by a new procedure for fiscal policy coordination. This would be based on quantitative guidelines, expressed as a percent of GDP, aimed at singling out inadequate fiscal performances and triggering a procedure of consultations and monitoring of the same kind as that applying to conditional Community credits.

In the monetary field:

- the 1964 Council Decision concerning the Committee of Governors is replaced by a new Decision giving greater authority and visibility to the Committee and making it the forerunner of the Council of the Monetary Institution to be created with the new treaty,
- the Committee would be responsible for determining the cost of the credit extended to member central banks;
- the Committee should be mandatorily consulted *ex ante* about domestic monetary policies; the outcome of this consultation together with a periodic assessment of member central bank monetary policy behaviour could be made public;
- *ex ante* consultation in the matters of common interest

concerning banking supervision;

- narrowing of margins of fluctuations from 2.25 to 1 (?) per cent;
- constitution of a staff to support and influence the deliberations of the Committee, to prepare the consultations and the public declarations.

b) Step two:

In the economic field:

- creation of the Economic institution;
- introduction of binding restrictions to the external borrowing and monetary financing to cover domestic budgetary deficits;
- creation of a European fiscal system as outlined in section 2 above: improved procedures, actions and resources for structural policies; a linkage between own resources of the Community budget and the budgetary situation of member states; etc.

In the monetary field:

- creation of the Monetary institution with all its decision-making organs and legal underpinnings (objective of monetary stability, autonomy, independence, accountability, decision-making procedures) according to Part I of the Report. The institution would incorporate all the present EMS and monetary arrangements (EMCF, Committee of Governors, competence over the ECU, etc.),
- the institution should have its own balance sheet, separated from those of member central banks, in order to carry out discretional interventions.

On the asset side it would have:

1) a certain amount of reserves, which would be definitively pooled allowing the conduct of interventions

in external currencies (dollar, yen);

2) credits to member central banks deriving from the power to grant them discretionary loans or to call reserves from them (symmetric "credit" mechanism); this would substitute all existing (predominantly automatic) credit mechanisms except for the pure very-short-term financing; this latter mechanism would remain in operation, albeit with shorter duration in order to induce central banks to have recourse to credit by the monetary institution.

On the liability side the monetary institution would have ECUs to be held (only?) by member central banks;

- the external monetary relations will become the sole responsibility of the Monetary institution: external interventions, participation in the monetary meetings of the G3, etc.;
- national monetary objectives will have to be agreed within the Monetary institution, and monitored by it;
- the Monetary institution will have the capacity to conduct intra-EMS interventions;
- anything about realignments?

c) Step three [final stage; this will have to be consistent with what is said in Part I. It should be observed that the so called "final stage" is not necessarily a stage beyond which the system will not be susceptible of further evolution. Rather, it is one in which the fundamental requirements of an economic and monetary union have been fulfilled albeit in a setting that may be subject to changes and improvements.].

In the economic field:

- the Economic institution will have the authority to impose constraints on national budgets when this is required to prevent imbalances that may threaten

+ conditions

monetary stability, or when it is required for the achievement of the desirable policy mix of the Community as a whole;

- the European fiscal system will come fully into force.

In the monetary field:

- parities will be irrevocably locked and the Monetary institution will start operating will full competence for the monetary policy decisions of the Community, as described in Part I;
- the common currency replaces gradually national currencies.

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