BANCA D'ITALIA

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847

SUPPORTO PER LA TRASMISSIONE/RICEZIONE DI FACSIMILE DI DOCUMENTI

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Numero di telefax 06-46.48.82

NOTE URGENT - CONFIDENTIAL

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All'attenzione di MR. G. BAER

DOCUMENTO: N. pagine 17 + 1 n. protocollo ______ (eventuale) del ______

Oggetto/descrizione SKELETON PART III

TRASMISSIONE: Data 17.11.88 richiedente T. PADOA-SCHIOPPA firma [signature]

Si autorizza: La Direzione [signature]

Trasmesso il 17.11.88 alle ore ______ n. sessione ______

L'Operatore ______

RICEZIONE: Ricevuto il ______ alle ore ______ n. sessione ______

L'Operatore ______ V° La Direzione ______

CONSEGNA:

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firma ______ data ______ ora ______

PART III

PROCEEDING BY STEPS

1. Principles

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

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

The Committee considers that a number or considerations have to be taken into account in designing a step-by-step approach to economic and monetary union.

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

A second and related consideration concerns parallelism and advancement by "blocs". 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. In the development of the Community advancement in certain areas has been combined with temporary standstill in others, thus adopting only partial parallelism. Examples of this method 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 in turn 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 participation. There is one Community, but not all the members participate fully in all its aspects from the beginning. So far this has mainly been the consequence of successive enlargements and, for the EMS, of the decision of some countries not to join the exchange rate agreement. A common adesion to the final objectives of the Community and a unitary acceptance of the same "rule of law" as well as participation in the same set of institutions should be preserved, while allowing for a degree of flexibility in the moment 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 calendar and the timing. The announcement of an exact deadline by 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 takes 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. Thus a certain degree of 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 least 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 would be stipulated on the basis of Article 236 of the Treaty of Rome, that would provide the legal basis for all the actions and developments that are necessary to reach the final stage of the economic and monetary union. Given the choice of a gradualistic approach, many clauses of the treaty will come into force only in later stages. 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 them. 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. Should it be adopted as the rule for all the stages? who should participate in the decision? Which body, or bodies, will take the decision? the european council may have to take the final decision, but what say will 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

Each of the two broad components of the union - economic and monetary respectively - covers different areas of economic and policy activity, for which the Committee has examined the main developments. In certain areas the conditions required for an economic and monetary union are the result of a continuous action to be developed in the legislative and executive sphere. In other areas these conditions can only be created through quantum jumps.

Before considering how the movement towards an economic and monetary union could be divided into discrete 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 certain controversial areas such 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) <u>arrangements to foster economic adjustment in conditions in which exchange rate changes will disappear</u>.

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 programme of doubling the resources of structural funds to 13 billion ECUs per year by 1992, coupled with the reorganization of the Community structural policies, significantly improves the ability of the Community to deal with these problems. However, the Committee considers that in a more advanced stage of the process these mechanisms should be further extended and made more effective. [In this section of the Report, the Committee may wish to indicate 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 of 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 proposals concerning the revision of the 1974 Decision].

2.2 Moving to the monetary union

The monetary union will result from progress in various areas which 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, establishment of one monetary policy, move from many national currencies to a single currency. For each of these fields, the evolution leading to a monetary union is briefly described below.

Describing the evolution towards a monetary union as a process involving separate progress in various segments of the monetary and financial system, however, fails to capture the strong interconnections between the areas, and underrates the need for "horizontal" consistency between the situations reached on each of 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 household or firm in all countries, 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.

i) irrevocable locking of parities, and unification of monetary policy.

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 a change in two categories of arrangements, concerning exchange rates and monetary policy respectively.

As to the first, a reformulation of the exchange rate agreement could consist in narrowing the existing margins and in reducing the frequency and size of realignments.

Narrowing the permitted margins of fluctuation is relatively simple from a technical point of view and will contribute to reduce uncertainty in the foreign exchange markets. What is more important, however, and more difficult to achieve, is to make realignments less frequent and smaller in size. This cannot be simply the effect of a new procedure concerning changes in parities. Above all it has to come as the consequence of a process of convergence towards low inflation and more homogeneous economic conditions. Excessive "dedramatization" of realignments would reduce the reluctance of governments to engage in such a procedure and ease the pressure for activating other adjustment mechanisms. But to enforce prolonged exchange rate stability against the fundamental conditions of the economies would generate tensions and distorsions. [The Committee may wish to take a position on this point and put forward a proposal.]

The second, and more important, category of arrangements concerns the transition 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. Such a transition requires a minimum harmonization of certain instruments, such as compulsory reserve requirements. However, the crucial part of the movement from many national monetary policies to one common policy concerns the definition of objectives and this can hardly be divided 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 even before a Community anchor is firmly established. [The Committee will give guidance about the message to be given in this crucial part of the Report. If the view were that the transition 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 <u>ex ante</u> consultation and by harmonizing certain instruments; secondly, suggesting criteria for deciding <u>when</u> this step should be taken].

<u>ii</u>) <u>The evolution of the ECU</u>.

In the present situation, with the ECU defined as a basket, official ECUs are created through the swaps mechanism and circulate only between EMS central banks. Meanwhile, in the market, various economic agents (corporations, financial institutions, public authorities) have adopted the ECU as a denomination for financial contracts, issues of securities, bank deposits, consolidated accounts for multi-national corporations, etc. No link exists between the private and the official circuit of the ECU, nor is there any autonomous process of money creation for the ECU. As explained in Part I, in the final stage of the monetary union the ECU will be the name of the single currency that replaces national currencies. Such ECU will no longer be defined as a basket and it will have all the features and functions of a currency.

The evolution from the present arrangements concerning the ECU to the final stage of the ECU becoming the single currency of the Community can follow alternative routes. One is to have, in addition to the arrangements and possibilities just mentioned, an autonomous process of money creation for the ECU, entrusted with the FEMI and parallel to the process of money creation for national currencies. The ECU would cease to be a basket. It would become an "abstract" ECU, and its parity would be determined jointly as part of the exchange rate agreement and defended by the Federal European Monetary Institution (FEMI). The policy could be one of granting the ECU a performance "at least as good as" the one of the strongest currency of the EMS. The ECU would exist in parallel with the national currencies until it replaces them. This route would give the ECU a potentially very large role in the Community and would require a monetary policy process for the ECU to be conducted in coordination with the national monetary policies.

Another route is to confine the ECU, until the last stage, to the role of a mere "denomination". This should be allowed to be freely and legally used by economic agents, but ECUs would not be autonomously created either by a national or the FEMI. To some extent this would permit economic agents to continue the long process of getting acquainted with the name and approximate value of the future common currency, to use it (if market participants so choose) to set prices, to keep corporate accounts, to label any kind of pecuniary obligation. To this end all regulatory impediments that now may prevent a more widespread use of the ECU as a denomination should be removed. This would involve no process of money creation in ECUs nor require establishing a "central bank for the ECU" operating along with central banks for national currencies.

[Future debates in the Committee will clarify the role of the ECU in the transition period as well as the advantages and problems of a parallel currency.]

iii) 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;

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 programme 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 a commom legislation, 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 FEMI would have to exert these functions, while preserving the maximum degree of decentralization compatible with the union.

2.3 <u>Evolution of the institutional setting</u>.

Part of the evolution leading to an Economic and monetary union is based on the Treaty of Rome and is already under way. On the other hand the process of drafting, approving and ratifying a new treaty will take time. This is why the movement to the Economic and Monetary union will be based initially on the Treaty of Rome as amended by the Single European Act and, from a certain point, on the new treaty.

The new treaty will create the Cënter for Economic Policy Decisions (CEPD) and the Federal European Monetary Institution (FEMI) as described in Part I of this Report. It will also set the programme and procedures to move to the economic and monetary union.

Following the principles of a step-by-step approach expressed above, the two institutions, with their organs and staff, would be put in place as soon as the treaty comes into force. Their staff and competences, however, would be initially small, and will grow gradually, as the programme laid out by the treaty will be implemented and the various enabling clauses activated.

3. <u>Three steps</u>

What follows is an hypothesis of moving to the economic and monetary union in three steps. [Such an hypothesis has been provisionally formulated on the basis of the discussions that the Committee has had so far, and in particular on the indication - emerged at the end of the

November meeting - that the first step could essentially consist of an upgrading of the Committee of Governors and the second on the creation of a new institution to which some reserves and some initial operational responsibilities would be entrusted.]

a) Step one [1990?]

In the institutional field:

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

In the economic field:

- complete removal of internal barriers and liberalization of exchanges of goods, services and capital within the Community, according to the single market programme adopted in the Single Act;
- complete implementation of the "Brussels package" of doubling the structural funds, whereby the ability of Community policies to promote regional development and to correct economic imbalances will be substantially strengthened;
- 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 percentage of GDP, aimed at singling out inadequate fiscal performances and triggering a procedure of consultation 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 would be 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 would be mandatorily consulted in advance of national decisions concerning domestic monetary policy;
- the outcome of the Committee's consultations together with a periodic assessment of monetary policies could be made public; the Committee would have the authority to address policy recommendations to the Council of the Community as well as to Member States;
- constitution of a permanent staff to prepare the deliberations of the Committee, to support the consultations and the public declarations;
- consultation in the matters of common interest concerning banking supervision;
- narrowing of margins of fluctuations from 2.25 to 1 (?) per cent.

b) Step two [to be enacted upon ratification of the new Treaty]

In the economic field:
- creation of the CEPD (Center for Economic Policy Decisions);
- introduction of binding restrictions to external borrowing and to monetary financing of domestic budgetary deficits; joint adoption of budgetary objectives as part of a coordinated budgetary policy;
- improved procedures, actions and resources for structural policies of the Community accompanying and supplementing the action of Member States; Community investment programmes in the fields of research and infrastructure;

In the <u>monetary</u> field:

- creation of the FEMI (Federal European Monetary Institution) described in Part I of this Report, with all its decision-making organs and legal underpinnings: mandate to preserve monetary stability, independence, accountability, decision-making procedures. The institution would incorporate 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.It would hold and manage a certain amount of reserves, which would be definitively pooled, denominated both in national and third currencies (dollar, yen). It would hold credits <u>vis-à-vis</u> member central banks deriving from the power to grant them discretionary loans that would substitute existing credit mechanisms (except for the pure very-short-term financing). On the liability side the monetary institution would have ECUs to be held by member central banks;
- the external monetary relations will become the responsibility of the FEMI: external interventions, participation in the monetary meetings with the US and Japan, etc.;
- national monetary objectives will be coordinated within the FEMI, and monitored by it;
- the FEMI will have the ability to conduct intra-EMS interventions in concertation with the interventions conducted by national authorities;
- the ECU will continue to be defined as a basket. Legislation will be passed to state that all obligations (in accounting, pricing and payment practices) foresseing the use of a currency denomination can be legally fulfilled by using the ECU denomination;

- [anything about realignments and exchange rate arrangements?]

c) Step three [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 Center for Economic Policy Decisions (CEPD) will have the authority to impose constraints on national budgets when this is required to prevent imbalances that may threaten monetary stability, or when it is required for the achievement of the desirable policy mix of the Community as a whole;

In the monetary field:
- parities will be irrevocably locked and the Federal European Monetary Institution will start operating will full competence for the monetary policy decisions of the Community, as described in Part I;

d) Last step
- the ECU replaces national currencies.

17.11.88