**COMMITTEE FOR THE STUDY OF**
**ECONOMIC AND MONETARY UNION**

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## Skeleton of the Report

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## I. The present state of and perspectives for economic and monetary integration in the Community

### 1. Introduction

This section will briefly recall the main features of the process of economic and monetary integration in Europe since the beginning of the 1970s. In particular, it will make reference to:

- the Werner Report, which presented a first attempt to define and set out a plan for the attainment of economic and monetary union;
- the perception by the mid-1970s that the process of integration had lost momentum; nonetheless a number of significant developments took place in the Community both in monetary areas (notably the establishment of the EMS) and in non-monetary fields;
- the new impetus to European integration in the mid-1980s, as reflected in the adoption of the internal market programme and the signing of the Single European Act;
- the fact that progress in one area has promoted advancement in other areas and that integration has now reached a stage where it is practically irreversible.

The section will conclude with a brief statement to the effect that the Community has proved able to overcome serious problems, has expanded as a result of the accession of new member countries and has revived the idea of economic and monetary union. In particular, it will stress that the Community is now on the move and that it has put its house in order by resolving the most urgent budgetary and policy issues.

### 2. Progress in monetary integration

This section will note that the recent progress in integration in Europe owed much to the European Monetary System, which has now been in operation for almost a full decade. Within the framework of the EMS the

Community has developed into a zone of monetary stability. The acceptance of the exchange rate constraint has greatly assisted 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, compared with exchange rate developments in the rest of the world, the achievements of a high degree of exchange rate stability between the currencies of the countries participating in the exchange rate mechanism. The EMS has served as a focal point for improved monetary policy co-ordination and provided a basis for multilateral surveillance within the Community. The success of the EMS has been in part attributable to the willingness of countries to opt for a strong currency policy stance, but also to the flexible management of the system, which has allowed it to evolve in response to changes in the economic and financial environment. [To be expanded.]

This section will also describe the evolution of the ECU, in its role both as an integral part of the EMS arrangements and as a market instrument. It will further point out that the ECU used by private market participants has not developed into a fully fledged currency but that its more widespread use in the market may reflect a perception that it could become the future currency of Europe.

## 3. Progress in economic integration

This section will describe the "relaunching" of Europe. The central element in this process was the proposal, made in 1985 by the Commission, to realise the objective of a unified economic area by 1992. The essence of the measures for the removal of physical, technical and fiscal barriers was set out in a White Paper, which specifies the programme, timetable and methods for implementing a market in which persons, goods, services and capital will be able to move freely. This objective, together with the necessary institutional means, was embodied in the Single European Act which marked the first significant revision of the Treaty of Rome. The adoption of the Single Act signalled in two important respects the Community's determination to advance more forcefully 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. Secondly, with the adoption of 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 and to promote the dialogue between management and labour, and to initiate action to protect the environment.

In order to ensure the credibility of the overall strategy as reflected in the Single Act, a package of accompanying policies was agreed in early 1988. These policies included decisions to adapt agricultural policy better to market conditions, to double the resources of the structural funds in order to assist less developed regions or adjustment in declining industries, and to provide the Community with sufficient and stable financial resources.

## 4. Perspectives and conclusions

This section will show that the implementation of measures envisaged in the internal market programme is well under way and point out that within the space of a few months numerous, important decisions have been taken affecting the movement of persons, goods, services and capital. In particular, the complete liberalisation of capital movements will become effective in most member countries by mid-1990. This will pose, on the one hand, a challenge to the cohesion of the exchange rate arrangements and thus necessitate a much closer co-ordination of monetary policies and, possibly, amendments to the operation of the EMS; but, on the other hand, it will foster a rapid integration of financial markets throughout the Community and improve the convergence of economic and monetary developments. At the same time agreements have recently been reached on a new approach to standards, the equivalence of diplomas and the partial opening-up of public procurement and insurance business. The implementation of these measures indicates that the process of completing the internal

market enjoys broad support, emanating to a significant extent also from the dynamic forces that the objective of 1992 has created at every decision-making level. In the private sector the anticipation effects are clearly reflected in the investment strategies of European firms and the unprecedented number of mergers foreshadowing the intensification of industrial co-operation. The prospects of a single market, the credibility of the member countries' desire to move towards a highly integrated Community and the enhancement of the decision-making capacity of Community bodies are having a strong impact on the behaviour of market participants in the Community.

In conclusion, the section will argue that the various policies envisaged in the Single Act will have to go hand in hand and that monetary and economic co-operation will have to be greatly strengthened if the single economic area is really to be achieved. While this will considerably advance the Community on its way to economic and monetary union, it does not mean that the Community will have moved to this final stage. To reach the final objective and thereby to take advantage of the Single Act with a view to fully developing the potential for economic growth and rising standards of living throughout the Community it will be necessary to create the functional and institutional arrangements outlined in the following two sections of the Report.

## II. How to define the final stage of economic and monetary union

### 1. Introduction

The establishment of an economic and monetary union will represent the final stage in the progressive process of economic integration in Europe. With the completion of this ultimate objective, the Community will form an area in which all residents can engage freely and without impediment in any kind of economic activity, subject only to commonly applied or mutually recognised rules and regulations and economic policies geared towards price stability, balanced growth and converging standards of living, high employment and external equilibrium. These policies will - to the extent necessary for an efficient economic

management - be formulated and carried out at the Community level. The functional and institutional arrangements of the economic and monetary union will have been implemented in accordance with a new Treaty.

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

An essential element of this solution is the observance of narrow limits in the attribution of competences to the Community. All the policy functions that can be exerted at the national (or even lower) level without prejudice for the functioning of the union should remain in the competence of member states. The competence of the Community should encompass only what is strictly necessary, and it should be subsidiary to that of lower levels of government. This means firm adherence to the principle of subsidiarity.

In its search for ways and means of gradually implementing economic and monetary union, the Committee is taking the view that a step-by-step approach to the final objective can be established only if there is a clear understanding of the meaning of economic and monetary union, its implications for the working of the economy and economic decision-making and the principal elements that have to be in place for its successful and durable functioning. Economic union and monetary union form two integral parts of a single whole and it is only for reasons of expositional clarity that in the following sections a distinction is drawn between them.

## 2. The principal features of monetary union

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

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

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

of a single currency area encompass, as already mentioned in the 1970 Werner Report:

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

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

However, the three macro-economic requirements emphasised in the Werner Report, while indispensable elements of a single currency area, would not necessarily lead by themselves to the degree of currency substitutability that would allow an easy move to a single currency. The continuing existence of national currencies - even if only for purely symbolic reasons - could cast doubt on the member countries' commitment to unchangeable exchange rate parities and thus engender divergent assessments of individual currencies in the market-place. Furthermore, even if fluctuation margins were abolished, the exchange of one currency for another would entail costs for commercial banks and could give rise to bid/offer spreads. Both developments would produce interest rate differentials between individual currencies, indicating that they were not yet considered to be perfect substitutes. For this reason a monetary union is not really achieved without the transition to a single currency. To this end complementary <u>measures of a micro-economic nature</u> are needed to ensure that different currencies are exchanged in the market-place in the same way as different bank notes of a national currency can be exchanged. [Is the recognition of the legal tender status of each national currency in each of the member countries of the Community necessary? Would an easy conversion system be helpful, i.e. a rebasing of currencies resulting in a set of

exchange rates that allows a quick and convenient comparison of prices expressed in different currencies?]

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

[A more detailed discussion of the preparatory measures for a move to a single currency requires guidance on: what should be the single currency? What role can the ECU play? Is it a suitable precursor of the Community's currency?]

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

As far as monetary policy is concerned, the adoption of fixed exchange rates in an environment of free and fully integrated capital and money markets means that there will no longer be scope for independent national monetary policies. The Community countries will therefore have to consent to <u>one</u> monetary policy and, by implication, <u>one</u> exchange rate policy vis-à-vis non-Community currencies. This presupposes that all member countries agree on the objectives of monetary policy and, as discussed in Section 4, that appropriate institutional arrangements have been made which allow the pursuit of a single monetary policy for the Community as a whole. In practice, however, the incision will not be so deep but will rather mark the completion of a progressively intensified co-ordination of national monetary policies, which had in many respects already foreshadowed the move to a single monetary policy in the Community. Even prior to the decision to

fix exchange rates permanently, the liberalisation of capital movements and financial market integration will have created a situation in which the conduct of monetary policy at the national level has been rendered extremely difficult. Once every banking institution in the Community is free to accept deposits from and grant loans to any customer in the Community and in any of the national currencies, the large degree of territorial coincidence between the national central banks' area of jurisdiction, the area in which their currency is used and the area in which "their" banking system operates, will be lost and it will only be possible for monetary policies to be effective if instruments of policy are harmonised and if broadly compatible objectives are pursued.

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

The most serious drawback of a monetary union is that the exchange rate can no longer serve as an instrument for adjusting economic

imbalances among member countries, shifting the need for adjustment to other market mechanisms and, as discussed in the next section, necessitating effective safeguards in non-monetary policy areas. Moreover, national balances of payments of member countries, even if statistics thereon are maintained, will no longer play the same role as at present. As a result two important sensitive indicators of disequilibria between countries - the exchange rate and the balance of payments - are no longer available as guideposts for policy-making.

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

## 3. The principal features of economic union

An economic union traditionally describes a unified and unrestricted market. However, it also requires certain arrangements in the field of non-monetary policy-making. Such arrangements are needed not only to ensure a smooth working of the unified market, but also to safeguard the functioning of monetary union.

As already pointed out in the 1970 Werner Report, an economic union implies first of all the realisation of a single market within which persons, goods, services and capital can move freely and without distortion of competition. The creation of this market presupposes a "level playing field" for all residents of the Community, which allows them to make decisions on production, investment and consumption in broadly similar

free choice

conditions and on the basis of similar levels of information. To this end two types of arrangements are necessary. Firstly, all barriers which tend to separate markets along national borders have to be eliminated. In particular, all technical and regulatory obstacles have to be removed, standards have to be harmonised or mutually recognised, and certain common minimum standards governing social policy and consumer and environmental protection have to be agreed. Moreover, tax treatment must not discriminate in favour of or against economic activities across Community countries. Secondly, competition policy - conducted at the Community level - has to operate in such a way that access to markets is not impeded and market functioning not distorted by the behaviour of private or public economic agents.

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

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

safeguards and appropriate institutional arrangements (discussed in Section 4) in at least two non-monetary areas.

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

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

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

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

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

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

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

## 4. Institutional arrangements

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

The creation of a monetary union necessitates the setting-up of a new monetary institution, placed properly in the constellation of Community institutions (European Council, Council of Ministers, European Parliament, Commission and Court of Justice). The implementation of economic union, too, requires institutional arrangements which enable policies in non-monetary fields to be determined or co-ordinated. This could require a revision and, possibly, some restructuring of existing Community institutions.

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

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

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

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

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

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

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

The mission of the Centre for economic policy decisions would be twofold. Firstly, it would operate to maximise the benefits of the economic and monetary union. Secondly, it would operate to reduce disequilibria which may arise in the process of economic integration. In accordance with the principle of subsidiarity most decisions would be left to national governments, with the Centre acting to increase the effectiveness of, and to remove possible inconsistencies between, national policies.

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

The procedures and arrangements for the implementation of a single market for persons, goods, services and capital have been laid down in the Treaty of Rome and the Single Act, conferring upon the Community the executive and judiciary authority to put the internal market programme into operation. To fulfil this programme on schedule, however, the Community

will still have to accomplish a heavy legislative task, covering certain controversial areas such as the harmonisation of indirect taxation. Moreover, to overcome a potentially serious problem of non-compliance with the growing body of Community legislation in support of the integrated internal market, it will be necessary to increase the effectiveness of the process whereby the Community law is enforced. [Any need for additional institutional measures?]

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

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

[This section of the Report could end with a discussion of, and some proposals on, two issues: the relationship between the European system of central banks and the Centre for economic policy decision; and the role these two institutions could play in the Community's external monetary and economic relations.]

## 5. <u>How to proceed?</u>

The implementation of economic and monetary union must, in accordance with Article 236 of the Treaty of Rome, be embodied in a new

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

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

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

e.g. in accordance with 236, unanimous decision by Council + after an agreement by the EPC with majority)

## III. **Concrete steps towards economic and monetary union**

### 1. Principles governing a step-by-step approach

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

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

The Committee is of the view that, in addition to the general principle of subsidiarity explained earlier in this Report, a number of considerations have to be taken into account in designing a step-by-step approach to economic and monetary union.

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

A second and related consideration concerns parallelism. Parallel advancement in many interrelated areas is an indispensable prerequisite for

the avoidance of imbalances which could cause economic disruptions and loss of political support for the continuing process of developing the Community into an economic and monetary union. Perfect parallelism, however, at each and every point of time is impossible and could even be counterproductive. Already in the past the advancement of the Community in certain areas has been combined with temporary standstill in others, thus involving a process of only partial parallelism. A certain amount of temporary deviations from parallelism is part of the dynamic evolutionary process of the Community. However, parallelism has to be maintained in the medium term.

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

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

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

approach has been adopted in the past by the Community and appears to be suited to putting the process of economic and monetary integration on a firm footing and giving it the necessary credibility and safeguards.

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

## 2. The role of the ECU

In Part II of this Report some arguments have been presented suggesting that the plan for a complete monetary union should include, at the end of the process, the transition to a single currency. It has not been discussed what this single currency should be. [The Committee has not yet discussed these matters. It will give guidance for drafting this part of the Report.] If it was decided that the ECU is ultimately to assume the role of the single Community currency, not only should it at the time of transition embody all features and functions of a currency, but it should also have attained widespread popularity and proved its usefulness in commercial and financial transactions. Only if the ECU has penetrated markets will it be an acceptable replacement for national currencies. Two approaches to promoting the ECU and preparing it for its future role as the single Community currency are conceivable.

The first course would build on existing arrangements. In particular, it would leave unchanged the basic provisions governing the creation and use of ECUs among national central banks (although the system of swaps could be replaced by an arrangement for a permanent exchange of official reserves for ECUs). This would not require the establishment of a link between officially created ECUs and ECUs used in the market as a

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

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

[In what form, i.e. as a standard basket or as an independently defined ECU? When should the new currency be introduced publicly as the Community's future currency? Should at the time of pronouncement the future currency be an additional currency existing alongside national currencies? Should it enjoy from the outset a superior status, for instance in terms of legal tender provisions or as "reserve money" for national central banks?]

## 3. Three concrete steps

What follows are two hypotheses of how to arrive at economic and monetary union in three steps. In each of the two scenarios each step would be the "entry point" to a new stage of the process leading to the economic

and monetary union. [Such provisional hypotheses have been formulated on the basis of documents and proposals presented to the Committee to date, suggesting that the first step could essentially consist of an upgrading of the Committee of Governors or, else, of the creation of a new institution to which some reserves and some initial operational responsibilities would be entrusted.]

### 3.1 ~~First~~ Scenario A

A (1) Stage one [to be enacted in conjunction with the coming into force of the directive on short-term capital movements.]

In the institutional field:

- preparation and ratification of the Treaty on the economic and monetary union, with a procedure similar to the one followed for the Single European Act.

In the economic field:

- complete removal of internal barriers and liberalisation of exchanges of goods, services and capital within the Community, according to the single market programme adopted in the Single Act;
- complete implementation of the "Brussels package" of doubling the structural funds, designed to strengthen substantially the ability of Community policies to promote regional development and to correct economic imbalances;
- replacement of the 1974 Council Decision on economic convergence by a new procedure for budgetary policy co-ordination. The revised 1974 convergence decision will provide for:

  - assessment and co-ordination - through recommendations - of the policy mix (taking due account of the recommendations of the Committee of Governors);

- a new procedure for budgetary policy co-ordination, with quantitative guidelines, where appropriate, and medium-term orientations;
- multilateral surveillance of economic performance and policies, on the basis of macro-economic indicators and within the framework of the EMS. Where developments are judged inadequate or detrimental to commonly set objectives, these would trigger at the Community level recommendations and endorsements to correct national policies;
- promotion, where felt appropriate, of concerted action of the member states.

In the monetary field:

- capital transactions: the coming into force of the June 1988 directive liberalising monetary movements in July 1990 will establish a regime of complete freedom of capital transactions. During this first stage a directive would be adopted to harmonise tax treatment of capital revenues to the extent that is necessary to avoid distortions in capital flows;
- policy co-ordination: the 1964 Council Decision defining the mandate of the Committee of Central Bank Governors would be replaced by a new decision giving the Committee greater authority and visibility and making it the forerunner of the Council of the European system of central banks to be created under the new Treaty. The Committee:

  - would be responsible for discretionally setting the interest rate to be charged on financing extended to member central banks under the very short-term and short-term EMS credit mechanisms;
  - would be consulted in advance of national decisions concerning the setting of yearly targets of domestic monetary policy;
  - would have the authority to make policy recommendations to central banks, individual governments and the Council of the Community. The outcome of its consultations, together with a

periodic assessment of monetary policies, could be made public;

- the Committee would submit an annual report on its activities and the monetary situation of the Community to the [European Parliament];
- a permanent staff would be constituted to prepare the deliberations of the Committee and to support its consultations and public declarations. The deliberations of the Committee would not be binding for member central banks;

- banking services and supervision: in the course of stage one all the necessary directives to liberalise the market for banking and other financial services would have to be approved, as planned under the programme for the completion of the internal market. A sub-committee of the Committee of Governors would start regular consultations concerning matters of common interest in the field of banking supervision;
- EMS arrangements: all member countries would adhere to the exchange rate mechanism of the EMS with the same fluctuation margins; [mechanisms of financial support would be strengthened to make the system fully equipped to counter, if needed, destabilising short-term capital movements;] margins of fluctuation would be narrowed from 2.25 to [1]%;
- ECU arrangements: removal of regulatory impediments that may prevent market participants using the ECU in setting prices, keeping corporate accounts, and contracting any kind of pecuniary obligations. The ECU remains a basket.

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

In the economic field:

- completion (if stage two began before end-1992) of the internal market programme, including the strengthening of Community competition policy and of the executive and judiciary authority to identify and sanction infringements of Community law;

- the Centre for economic policy decisions (CEPD) would start operating with a view to promoting convergence and co-ordination of economic policy in the Community. [Following the programme set out in the new Treaty, legislative and executive measures would be taken, at the Community as well as the national level, leading to the creation of a European Fiscal Framework (EFF). Such a system would cover: essential tax harmonisation; the respective roles of national and Community budgets; "own" resources of the Community budget; the size of budget deficits and their financing;]
- [in accordance with the programme for the EFF,] this stage would include:

  - introduction of rules relating to the size of the budget deficits and their financing;
  - adoption of medium-term guidelines for key financial targets and economic programmes in the member states;
  - joint adoption of budgetary objectives, when felt appropriate, as part of a co-ordinated budgetary and economic policy;
  - enlargement of resources for supporting the structural policies of the member states and strengthening the Community investment programmes in the fields of research and infrastructures.

In the monetary field:

- creation of the European system of central banks (ESCB) described in Part I of this Report, with its central body (the Federal European Monetary Institution - FEMI), decision-making organs (Board and Council), balance sheet, and legal underpinnings: mandate to preserve price stability, independence, accountability, decision-making procedures. The institution would incorporate the present monetary arrangements (EMCF, Committee of Governors, competence over the ECU, etc.). In the initial stage of the new institutional setting created in accordance with the Treaty on economic and monetary union, the ESCB's tasks would be

confined to limited actions in the field of exchange rate managements, while domestic monetary policies would be conducted by national central banks under a procedure for co-ordination and consultation (see below);

- the actions of the FEMI in the field of foreign exchange management would be restricted to exchange market interventions, and would essentially serve two purposes: to create a "training ground" for the future role of the system and to give to markets signals of concerted interventions. In order to fulfil this task the FEMI would hold and manage a small amount of reserves. To this end the FEMI should have its own balance sheet, separated from those of member central banks. It would contain on the asset side official reserves, which would be definitively pooled and result from the contribution by each member country of convertible currencies other than its own, denominated both in Community and third currencies. Other assets would consist of credits extended to member central banks, reflecting the FEMI's power to grant discretionary loans which would take the place of existing credit mechanisms (except for the very short-term financing). On the liability side the FEMI's balance sheet would have ECU liabilities to member central banks;
- the FEMI could conceivably assume [three] functions:

  - interventions in third currencies;
  - entitlement to conduct intra-EMS interventions;
  - [representation of the Community in international monetary meetings, for instance in discussions with the United States and Japan;]
  - [two hypotheses can be put forward about the scope of foreign exchange operations conducted by the FEMI, depending on how important a role the FEMI should play at this intermediate stage. According to a first (soft) hypothesis, the Board of the FEMI would intervene only on the basis of case-by-case approval received in the concertation procedure by member central banks (Council of the ESCB). According to a second (hard) hypothesis interventions by the FEMI would be left to the discretion of the Board, which would base its

decisions on monthly guidelines established by the Council of the system. In either case the overall size of FEMI interventions would be small - at least initially - and not imply a significant shift of the intervention policy from the network of national central banks to the FEMI. Consideration could also be given to the idea of implementing the soft and the hard hypothesis at different junctures in the course of this stage two;]

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

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

[N.B. Owing to the small size of FEMI interventions and to the firm control exercised by the Council of the ESCB, the impact of FEMI operations on domestic monetary conditions of member countries should be negligible. Its main function would be to provide a signal to the market.]

A 3 (4) <u>Stage three</u> [this corresponds to the final stage described in Part II. It should be observed that the so-called "final stage" is not necessarily a stage beyond which the system would not be susceptible to further evolution. Rather, it is one in which the fundamental requirements of an economic and monetary union would have been fulfilled, albeit in a setting that might be subject to changes and improvements.]

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

- the Centre for economic policy decisions would be given the authority to impose constraints on national budgets when this is necessary to prevent imbalances that may threaten monetary stability;

- discretionary changes (through a procedure to be defined) in Community resources to supplement structural transfers to member states or to influence the overall policy stance in the Community;
- discretionary changes (through a procedure to be defined) in the level of harmonised taxation rates;
- capacity to apply some form of conditionality to existing Community budgetary transfers and to Community loans (as a substitute for the present medium-term loans facility).

In the monetary field:

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

D (4) Last stage

- the ECU replaces national currencies.

3.2 Scenario B

B (1) Stage one [to be enacted in conjunction with the coming into force of the directive on short-term capital movements.]

- in the institutional field: the same as in A (1);

- in the economic field: the same as in A (1);

- in the monetary field:

  - capital transactions: the same as in A (1);
  - banking services and supervision: the same as in A (1);

- <u>EMS and policy co-ordination</u>: following the procedure used in 1978 for the creation of the EMS (a Resolution of the European Council followed by an agreement between central banks) a reform of EMS arrangements would be implemented along the following lines:

  - creation of a Fund [replacing EMCF?] with the task of intervening in third currencies on the basis of case-by-case instructions received by central banks. Interventions would be small and would serve the two purposes of creating a "training ground" and providing a signal effect through concerted interventions;
  - [extension of the duration of swaps or pooling of reserves?]
  - [incorporating existing financing mechanisms into the Fund; equipment of the Fund with the instruments that are deemed necessary to counter, if needed, destabilising short-term capital movements;]
  - [attribution to the Fund of a role (con-current to the one of national central banks) in international monetary meetings and co-operation;]
  - the Fund would be placed under the authority of the Committee of Governors;
  - "upgrading" of the Committee of Governors, that would become the forerunner of the Council of the ESCB. The Committee would have the authority to: make policy recommendations; set interest rates on EMS credit mechanisms; give advice on yearly monetary targets; present an annual report;
  - adhesion of all member countries to the ERM of the EMS with the same [fluctuation] margins; [narrowing of margins?]

- <u>ECU developments</u>: the same as in A (1).

B (2) Stage two [to be enacted when the new Treaty comes into force.]

- In the economic field: the same as in A(2);

In the monetary field:

- creation of the European system of central banks (ESCB) described in Part II of this Report, with its central body (the Federal European Monetary Institution - FEMI), decision-making organs (Board and Council), balance sheet, and legal underpinnings. The institution would incorporate the pre-existing monetary arrangements (the Fund created in stage one, Committee of Governors, competence over the ECU, etc.). The FEMI would hold and manage a small amount of official reserves, which would be definitively pooled and result from the contribution by each member country of convertible currencies other than its own. The FEMI would also have the power to grant discretionary loans which would take the place of existing credit mechanisms (except for the very short-term financing). On the liability side the FEMI's balance sheet would have ECU liabilities to member central banks;

- in the field of foreign exchange management the FEMI could:

  - intervene in third currencies. Interventions of the FEMI would be decided by the Board on the basis of monthly guidelines established by the Council of the system;
  - be entitled to conduct intra-EMS interventions;
  - [represent the Community in international monetary meetings, for instance in discussions with the United States and Japan;]

- in the field of domestic monetary policy the FEMI would:

  - act as the forum for [binding?] ex ante co-ordination of national annual monetary targets and decisions in the process of monetary policy implementation;

- [be entitled to release or call reserves of national central banks consistent with national monetary developments agreed in the process of policy co-ordination.]

[N.B. Owing to the small size of FEMI interventions and to the firm control exercised by the Council of the ESCB, the impact of FEMI operations on domestic monetary conditions of member countries should be negligible. Its main function would be to provide a signal to markets.]

B(3) Stage three: the same as in A(3).

B(4) Last stage: the ECU replaces national currencies.