COMMITTEE FOR THE STUDY OF
ECONOMIC AND MONETARY UNION

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

1. Introduction

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

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

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

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

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

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

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

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

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

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

3. The Single European Act and the Internal Market Programme

6. On the economic side, a "relaunching" of Europe began in the mid-1980s supported by the success of the EMS. The central element in this process was the proposal, made in May 1985 by the Commission, to realise the objective of a market without internal frontiers by 1992. The essence of the measures for the removal of physical, technical and tax barriers was set out in a White Paper, which specifies the programme, timetable and methods for creating a unified economic area in which persons, goods, services and capital will be able to move freely. This objective, together with the necessary institutional steps, was embodied in December 1985 in the Single European Act which marked the first significant revision of the Treaty of Rome.

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

8. Considerable progress has been made over the last three years in implementing the internal market programme. This highlights a marked change

of pace in approaching a unified market, as compared to the developments during the previous two decades.

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

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

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

4. Perspectives, opportunities and problems

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

11. The single market will entail profound structural changes in the economies of the member countries. The abolition of market barriers will link national economies much more closely together and significantly increase the degree of economic integration within the Community. These changes offer immense opportunities for economic advancement but many of the potential gains can only materialise if economic policy-making is adjusted in response to the structural changes. The opportunities arise

because the unified enlarged economic space greatly increases the freedom of choice of market participants, generates large possibilities for exploiting economies of scale and comparative advantages and reduces the administrative costs of intra-Community trade. There can be no doubt that these changes prepare the ground for a more efficient use and allocation of resources with beneficial effects for trade, growth and employment. However, the extent to which these gains can be achieved depends critically on the degree of certainty surrounding the decision-making of private market participants. The single market will greatly strengthen economic interdependence between member countries and amplify the cross-border effects of development originating in each member country. If national policies are not brought in line the participants in the single market will be facing conflicting signals which will not only create an unfavourable climate of uncertainty, but over time will give rise to economic imbalances which might necessitate more frequent exchange rate realignments or recourse to safeguard clauses. The existence of a common market in which separate national authorities determine economic policies thus imposes a strong constraint on their room for independent manoeuvre and requires a high degree of policy co-ordination. This is most obviously the case in the field of monetary policy where in a situation of freedom of capital movement and integrated financial markets incompatible nation policies would translate quickly into exchange rate pressures. But it also applies to all other areas of national economic management.

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

12. As the success of the internal market programme hinges to a decisive extent on more effective Community policies as well as a close co-ordination of national economic policies, it implies that in essence a number of the steps towards <u>economic and monetary union</u> will already have

to be taken in the course of establishing a single market in Europe. As will be discussed in the following Part of the Report, an economic and monetary union encompasses a common market for persons, goods, services and capital, a single currency area and a set of arrangements designed to ensure a coherent and effective economic management for the Community as a whole. In this sense economic and monetary union will add to the internal market programme two principal elements. Firstly, it will set up explicitly a policy framework which will replace the present ad hoc procedures for voluntary policy co-ordination by a system defining clearly the distribution of policy responsibilities exercised at the Community and the national levels, and thereby guarantee a consistent economic management. Secondly, it will create a single currency area through an irrevocable locking of exchange rates or the introduction of a single currency, and thereby enhance strongly the potential of the single market. Although in many respects a natural sequence to the commitment to create a market without internal frontiers, the move towards economic and monetary union represents a quantum jump which will secure a significant increase in economic welfare in the Community.

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

14. Secondly, a closely co-ordinated management of macro-economic policies is not only vital for the cohesion of an economic and monetary union, but it also offers the possibility of systematically exploiting the reciprocal room for manoeuvre under a co-operative strategy and attaining a higher rate of growth and employment. Within a clearly defined framework for policy-making the interdependence of economic developments in individual member countries would be automatically taken into account and thereby ensure the most favourable outcome from the interactions of national policies. For instance, the Cecchini Report estimated that the impact of the internal market programme on growth in the Community could be raised by 2½ percentage points if the removal of market barriers were accompanied by an active macro-economic policy in the Community. An economic and monetary union would greatly enhance the changes for implementing such a well co-ordinated growth-oriented strategy.

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

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

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

17. Economic and monetary union has been set as a goal by the Community since the late 1960s. The single market, by itself, does not require the establishment of an economic and monetary union. It requires, however, a significant increase in the degree of economic policy co-operation even in areas that are not, as such, part of the single market programme. Such an increase represents a significant progress on the path leading to an economic and monetary union. This is the reason why the European Council in Hannover has decided to consider again the problem of

an economic and monetary union and the steps leading to it. These are the subject matters of Parts II and III of this Report.