COMMITTEE FOR THE STUDY OF
ECONOMIC AND MONETARY UNION

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Draft

REPORT ON ECONOMIC AND MONETARY UNION IN THE EUROPEAN COMMUNITY

This report has been prepared in response to the mandate of the European Council "to study and propose concrete stages leading towards economic and monetary union".

Foreword

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

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

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I. **<u>Past and present developments in economic and monetary integration in the Community</u>**

1. <u>The objective of economic and monetary union</u>

1. In 1969 the Heads of States and Governments, meeting in The Hague, agreed that a plan should be drawn up with a view to the creation, in stages, of an economic and monetary union within the Community. This initiative was taken against the background of major achievements by the Community in the 1960s: the early completion of the transition period leading to a full customs union, the establishment of the common agricultural policy and the creation of a system of own resources. At the same time the Bretton Woods system was showing signs of decline. The <u>Werner Report</u>, prepared in 1970, presented a plan for the attainment of economic and monetary union. In March 1971, following the Werner Report, member states expressed "their political will to establish an economic and monetary union".

2. Several important <u>moves followed</u>: 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. Yet, by the mid-1970s the process of integration had lost momentum under the pressure of divergent policy responses to the economic shocks of the period.

3. In 1979 the process of monetary integration was relaunched with the creation of the <u>European Monetary System</u> (EMS) and the European Currency Unit (ECU). The success of the EMS in promoting its objectives of internal and external monetary stability has contributed in recent years to further progress, as reflected in the adoption, in 1985, of the internal market programme and the signing of the Single European Act.

2. The European Monetary System and the ECU

4. The European Monetary System was created by a Resolution of the European Council followed by a Decision of the Council of Ministers and an Agreement between the participating central banks.

5. Within the framework of the EMS the participants in the exchange rate mechanism have succeeded in creating a zone of increasing monetary stability at the same time as gradually relaxing capital controls. The exchange rate constraint has greatly helped those participating countries with relatively high rates of inflation in gearing their monetary policy towards the objective of price stability, thereby laying the foundations for both a downward convergence of inflation rates and the attainment of a high degree of exchange rate stability. This, in turn, has helped moderate cost increases in many countries, and led to an improvement in overall economic performance. Moreover, reduced uncertainty regarding exchange rate developments and the fact that the parities of the participating currencies have not been allowed to depart significantly from economic fundamentals have protected intra-European trade from excessive exchange rate volatility.

The EMS has served as the focal point for improved monetary policy co-ordination and has provided a basis for multilateral surveillance within the Community. In part, its success can be attributed to the participants' willingness to opt for a strong currency stance. Also important has been the flexible and pragmatic way in which the System has been managed, with increasingly close co-operation among central banks. Moreover, the System has benefited from the role played by the Deutsche Mark as an "anchor" for participants' monetary and intervention policies. 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 mechanisms have been extended and strengthened.

At the same time, the EMS has also suffered from a number of weaknesses. The lack of convergence of fiscal policies as reflected in large and persistent budget deficits in certain countries has remained a source of tensions and has put a disproportionate burden on monetary policy. Moreover, a number of Community countries have not yet joined the exchange rate mechanism and one country participates with wider fluctuation margins. The transition to the second stage of the EMS and the establishment of the European Monetary Fund, as foreseen by the Resolution of the European Council adopted in 1978, have not been accomplished.

6. In establishing 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 to denominate 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. Although it is an integral part of the EMS, the ECU has for a number of reasons played only a limited role in the operating mechanisms of the EMS. One reason is that compulsory intervention and the build-up of intervention balances to be settled in ECU has remained rather limited as central banks have increasingly had recourse to intra-marginal intervention involving the use of partner currencies.

By contrast, the ECU has gained considerable popularity in the market place, where its use as a denominator for financial transactions has spread significantly. In international banking, the ECU is at present the sixth most important unit of denomination and it ranks fifth in international bond issues, with a 6% market share. A wide set of ECU instruments is available for investors, at both the short and the long end of the market. Moreover, the creation of an ECU clearing system, in which more than thirty commercial banks now participate, has contributed to the development and liquidity of the ECU market, as has the issue of short-term bills by the UK Treasury.

The expansion of financial market activity in ECU reflects in part a growing issuance of ECU-denominated debt instruments by Community institutions and public sector authorities of some member countries, and in part the ECU's attractiveness as a means of portfolio diversification and as a hedge against currency risks. However, the evolution of the ECU market has been rather uneven. International banking business in ECU and new ECU Euro-bond issues grew vigorously in the first half of this decade, but have moderated since then. The lion's share of banking business represents interbank transactions, whereas direct business with non-banks has remained relatively small and appears to have been driven primarily by officially encouraged borrowing demand in a few countries. Moreover, ECU-denominated deposits by the non-bank sector have stagnated since 1985, suggesting that the ECU's appeal as a near money substitute and store of liquidity is modest. In addition, in the non-financial sphere the use of the ECU for the invoicing and settlement of commercial transactions has remained limited, covering at present only about 1% of the Community countries' external trade.

3. The Single European Act and the internal market programme

7. In January 1985 the Commission proposed realising the objective of a market without internal frontiers by the end of 1992. The detailed measures for the removal of physical, technical and fiscal barriers were set out in a White Paper, which specified the precise programme, timetable and methods for creating a unified economic area in which persons, goods, services and capital would be able to move freely. This objective was embodied in December 1985 in the Single European Act.

8. The Single European Act marked the first significant revision of the Treaty of Rome. It introduced three important changes in the Community's strategy for advancing the integration process. Firstly, it 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, it established a faster, more efficient and more democratic decision-making process by extending the scope of qualified majority voting and by giving the European Parliament a greater role in the legislative process. Thirdly, it reaffirmed 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 base, 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.

9. Over the last three years considerable progress has been made in implementing the internal market programme. In particular, it has been decided that eight member countries will fully liberalise capital movements by 1st July 1990 and that the other member countries will follow suit after a period of transition.

In December 1988 the European Council, meeting in Rhodes, 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 the broad support of consumers and producers and that their economic decisions are increasingly influenced by the prospects of 1992. The anticipation of a market without internal frontiers has generated a new dynamism and has contributed to the recent acceleration of economic growth in the Community.

4. Problems and perspectives

10. The completion of the single market will link national economies much more closely together and significantly increase the degree of economic integration within the Community. This will offer considerable opportunities for economic advancement because a unified enlarged economic area will greatly increase the freedom of choice of market participants, raise their purchasing power and generate considerable possibilities for exploiting economies of scale and comparative advantage.

However, these potential benefits will not be achieved without significant structural adjustment. Both private market participants and policy makers will have to adapt their behaviour to changes in legislation and to the evolving economic environment.

11. Although substantial progress has been made, the process of integration has been uneven. Greater convergence of economic performance is needed. Despite a marked downward trend in the average rate of price and wage inflation, there are considerable differences between countries. There are also still notable divergences in budgetary positions and external imbalances have become markedly greater in the recent past. The existence of these disequilibria indicates that there are areas where economic performances will have to be made more convergent.

12. As economic interdependence increases, the room for independent policy manoeuvre will decrease. With full freedom of capital movements and

integrated financial markets incompatible national policies would quickly translate into exchange rate tensions and put an increasing and undue burden on monetary policy if exchange rate realignments or recourse to safeguard clauses were to be avoided. The integration process thus requires more intensive and effective policy co-ordination, not only in the monetary field but also in other areas of national economic management affecting aggregate demand, prices and costs of production.

A tighter co-ordination of economic policy-making is required. In the monetary field, the weaknesses of the EMS referred to above continue to exist. Outside the EMS, policy co-ordination remains largely perfunctory. Especially in the area of fiscal policy the 1974 Decision on economic convergence has not succeeded in establishing an effective foundation for policy co-ordination. The pressure for mutually consistent macro-economic policies has until now been lessened to some extent by the existence of capital controls in some countries and by the segmentation of markets through various types of non-tariff barriers. But full mobility of capital will become effective in 1990 and as the internal market programme is implemented each country will be less and less shielded from developments elsewhere in the Community. The attainment of national economic objectives will become more dependent on a co-operative approach to policy-making.

13. National decision-making authorities are subject to many pressures and institutional constraints and even best efforts to take into account the international repercussions of their policies are likely to fail at certain times. While voluntary co-operation should be relied upon as much as possible to arrive at increasingly convergent national policies, thus taking account of divergent constitutional situations in member countries, there is also likely to be a need for more binding procedures.

14. At its meeting on 27th-28th June 1988, the European Council confirmed the objective of economic and monetary union for the Community. The completion of the internal markets without frontiers will mark an important step in this direction, but does not by itself lead to the attainment of the final objective. Economic and monetary union implies far more than the single market programme and, as discussed in the following two Parts of this Report, will require further major steps in all areas of economic policy-making.

15. In accordance with its mandate, the Committee has focused its attention on the technical question of how to achieve economic and monetary union. The question of whether and, if so, when economic and monetary union is desirable is a matter for political decision. This Report therefore examines the conditions under which such a union could be viable and successful.

16. The Committee feels that concrete proposals leading to economic and monetary union can only be made if there is a clear understanding of the implications and requirements of the final objective and if due account is taken of past experiences with and developments in economic and monetary integration in the Community. For this reason, Part II of this Report examines the principal features and implications of an economic and monetary union. Part III then presents a pragmatic step-by-step approach which could lead in three stages to the final objective.

II. **The final stage of economic and monetary union**

1. General considerations

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

18. Even after attaining economic and monetary union, the Community would continue to consist of independent nations with differing economic characteristics, traditions, social customs and languages. The existence and preservation of this plurality would require a degree of autonomy in economic decision-making to remain with individual member countries and a balance to be struck between national and Community competences. For this reason it would not be possible simply to follow the example of existing federal states; it would be necessary to develop an innovative and unique approach.

19. The Treaty of Rome, as amended by the Single European Act, provides the legal foundation for many of the necessary steps towards economic integration, but does not suffice for the creation of an economic and monetary union. The realisation of this objective would call for new arrangements which could only be established on the basis of a new Treaty and consequent changes in national legislations. The Treaty would lay down the functional and institutional arrangements, as well as provisions governing their step-by-step implementation.

20. Taking into account what is already provided for in the EC Treaties, the need for a transfer of decision-making power from member states to the Community as a whole would arise primarily in the fields of

monetary policy and macro-economic management. A monetary union would require a single monetary policy and responsibility for the formulation of this policy would consequently have to be vested in one decision-making body. In the economic field a wide range of decisions would remain in the preserve of national and local authorities. However, given their potential impact on the overall domestic and external economic situation of the Community and their implications for the conduct of a common monetary policy, such decisions would have to be placed within an agreed macro-economic framework and be subject to binding procedures and rules. This would allow the determination of an overall policy stance for the Community as a whole, avoid major differences between individual member countries in public sector borrowing requirements and place binding constraints on the financing of budget deficits.

Economic union is the basis for economic and monetary union and it can only be defined in the light of monetary constraints

21. An essential element in defining the appropriate balance of power within the Community would be strict adherence to the constitutional "principle of subsidiarity", according to which the functions of higher levels of government should be as limited as possible and should be subsidiary to those of lower levels. Thus, the attribution of competences to the Community would have to be confined to those areas in which collective decision-making was necessary. All policy functions which could be carried out at national (and regional and local) levels without adverse repercussions on the cohesion and functioning of the economic and monetary union would remain within the competence of the member countries.

22. Economic union and monetary union ~~are closely intertwined. They~~ form two integral parts of a single whole and would therefore have to be implemented in parallel. It is only for reasons of expositional clarity that the following sections look separately at the principal features defining an economic and a monetary union. The description begins with monetary union ~~chiefly because an economic union can be circumscribed more clearly and specifically once the main elements of a monetary union have been identified.~~

The Committee is fully aware that

~~The process of achieving~~ monetary union is only conceivable if ~~there~~ a high degree of economic convergence is ~~achieved~~ attained

While [illegible] it would

and it is also for the same reason that

2. The principal features of monetary union

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

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

The first two of these requirements have already been met, or will be with the completion of the internal market programme. The single most important condition for a monetary union would, however, be accomplished only when the decisive step was taken to lock exchange rates irrevocably.

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

This is likely to work for a limited period only and might need the expectation of the introduction of a single currency

end para 24

24. The three above-mentioned requirements define a single currency area, but their fulfilment would not necessarily mark the end of the process of monetary unification in the Community. The adoption of a single currency, while not strictly necessary for the creation of a monetary union, might be seen - for economic as well as psychological and political reasons - as a natural and desirable further development of the monetary

provided that its stability is ensured.

and avoid the transaction costs of converting currencies. A single currency would also

union. A single currency would clearly demonstrate the irreversibility of the move to monetary union, considerably facilitate the monetary management of the Community ~~and have a much greater weight relative to other major currencies than any individual Community currency~~. [The replacement of national currencies by a single currency ~~would take a certain~~ time. ~~It would presuppose that economic agents had become sufficiently acquainted with the new currency.~~]*

25. The establishment of a monetary union would have far-reaching implications for the formulation and execution of monetary policy in the Community. Once permanently fixed exchange rates had been adopted, there would be a need for a single monetary policy, which would be carried out through new operating procedures. The co-ordination of as many national monetary policies as there were currencies participating in the union would not be sufficient. The responsibility for the single monetary policy would have to be vested in a new institution, in which centralised and collective decisions on the supply of money and credit in the Community would be taken.

This shift from national monetary policies to a single monetary policy is an inescapable consequence of monetary union and constitutes one of the principal institutional changes. Although a progressively intensified co-ordination of national monetary policies would in many respects have prepared the way for the move to a single monetary policy, the implications of such a move would be far-reaching. ~~Together with~~ the permanent fixing of exchange rates it would deprive individual countries of the principal instrument available to correct economic imbalances and act independently in pursuit of national objectives, especially price stability. This loss would be most intensely felt by those countries that had retained some room for manoeuvre to pursue stability objectives under the less binding EMS rules.

Even prior to the decision to fix exchange rates permanently, the full liberalisation of capital movements and financial market integration will create a situation in which the co-ordination of monetary policy will have to be strengthened progressively. Once every banking institution in the Community is free to accept deposits from, and to 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

(Para. 24) Leigh-Pemberton would prefer the introduction of a single currency as soon as possible after the locking.

* PLEASE NOTE THAT THE SQUARE BRACKETS IN THE TEXT INDICATE THE PASSAGE TO WHICH THE REMARKS IN THE RIGHT HAND MARGIN REFER.

Schlesinger favours taking place as ~~the introduction of a single currency than at~~ soon as possible after the locking of parities.

of jurisdiction, the area in which their currency is used and the area in which "their" banking system operates will be lost. In these circumstances the effectiveness of national monetary policies will become increasingly dependent on co-operation among central banks. Indeed, the growing co-ordination of monetary policies will make a positive contribution to financial market integration and will help central banks gain the experience that is necessary to move to a single monetary policy.

3. The principal features of economic union

26. Economic union - in conjunction with a monetary union - combines the characteristics of an unrestricted common market with a set of rules which are indispensable to its proper working. In this sense economic union can be described in terms of four basic elements:

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

In defining specific rules and arrangements governing an economic union, the Community should be guided by two considerations.

Firstly, the economic union should be based on the same market-oriented economic principles that underlie the economic order of its member countries. Differences in policy choices may exist between member countries or - within the same country - in different periods. However, beyond such differences, a distinctive common feature of economic systems in Europe is the combination of a large degree of freedom for market behaviour and private economic initiative with public intervention in the provision of certain social services and public goods.

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

27. The creation of a single currency area would add to the potential benefits of an enlarged economic area because it would remove intra-Community exchange rate uncertainties and reduce transactions costs, eliminate the possibility of exchange rate movements unwarranted by fundamental factors, contribute in the longer run to the evolution of a ~~more homogeneous economic structure~~ in the Community and reduce the susceptibility of the Community to external shocks.

At the same time, however, exchange rate adjustments would no longer be available as an instrument to correct economic imbalances within the Community. Such imbalances might arise because the process of adjustment and restructuring set in motion by the removal of physical, technical and fiscal barriers is unlikely to run smoothly or always produce satisfactory results within reasonable periods of time. Imbalances might also emanate from labour and other cost developments in one member country, external shocks with differing repercussions on individual economies, or divergent economic policies pursued at national level.

With parities irrevocably fixed, foreign exchange markets would cease to provide a source of pressure for national policy corrections when national economic disequilibria developed and persisted. Moreover, the statistical measurement and the interpretation of economic imbalances might become more difficult because in a fully integrated market balance-of-payments figures, which are currently a highly visible and sensitive indicator of economic disequilibria, would no longer play such a significant role as a guidepost for policy-making. Nonetheless, such imbalances, if left uncorrected, would manifest themselves as regional disequilibria. Measures designed to strengthen the mobility of factors of production would be one way to deal with such imbalances.

28. To create an economic and monetary union the single market would have to be complemented through action in three interrelated areas: competition policy and other measures aimed at strengthening market mechanisms; common policies to enhance the process of resource allocation

and

in those economic sectors and geographical areas where the working of market forces needed to be reinforced or complemented; macro-economic co-ordination, including binding rules in the budgetary field and other arrangements both to limit the scope for divergences between member countries and to design an overall economic policy framework for the Community as a whole.

29. <u>Competition policy</u> - conducted at the Community level - would have to operate in such a way that access to markets would not be impeded and market functioning not be distorted by the behaviour of private or public economic agents. Such policies would have to address conventional forms of restrictive practices and the abuse of dominant market positions, but would also have to deal with new aspects of antitrust laws, especially in the field of merger and takeover activities. The use of government subsidies to assist particular industries should be strictly circumscribed because they distort competition and cause an inefficient use and allocation of scarce economic resources.

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

The impact of economic and monetary integration on regional disparities is difficult to assess: on the one hand, those less developed regions with lower wage levels would be provided with an opportunity to attract modern and rapidly growing service and manufacturing industries for which the choice of location would not necessarily be determined by transport costs and market proximity. On the other hand, however, transport costs and economies of scale would tend to favour a shift in economic activity away from less developed regions, especially if they were at the periphery of the Community, to the highly developed areas at its centre.

The economic and monetary union would have to encourage and guide structural adjustment which would help poorer regions to catch up with the wealthier ones.

A step in this direction was taken in February 1988 when the European Council decided to strengthen and reorganise the Community's regional and structural policies in several respects: the size of structural funds will be doubled over the period up to 1993, emphasis will be shifted from project to programme financing, and a new form of partnership will be established between the Community and the receiving regions. In the process of creating economic and monetary union such policies might have to be strengthened further after 1993, depending upon the speed of progress towards economic and monetary union.

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

Apart from regional policies, the Treaty of Rome, as amended by the Single European Act, has established the basis for Community policies in areas such as infrastructure, research and technological development, and environment. Such policies would not only enhance market efficiency and offset market imperfections, but could also contribute to regional

(Para. 30, 4th and 5th sub-paras.) Leigh-Pemberton suggests that the second full para. on p. 15 and the next para. ending at the top of p. 16 could be omitted.

development. While respecting the principle of subsidiarity, such policies would have to be developed further in the process towards economic and monetary union.]

[If wage flexibility and labour mobility are insufficient to eliminate differences in competitiveness in different regions and countries of the Community, there could be relatively large declines in output and employment in areas with deteriorating competitiveness. In order to reduce adjustment burdens temporarily, it might be necessary in certain circumstances to provide financing flows through official channels. Such financial support would be additional to what might come from spontaneous capital flows or external borrowing and should be granted on terms and conditions that would prompt the recipient to intensify its adjustment efforts.]

31. Macro-economic policy is the third area in which action would be necessary for a viable economic and monetary union. This would require an appropriate definition of the role of the Community in promoting price stability and economic growth through the co-ordination of economic policies.

The major developments affecting macro-economic conditions would continue to be determined by factors and decisions operating at the national level. This would apply not only to wage negotiations and other economic decisions in the fields of production, savings and investment, but also to the action of public authorities in the economic and social sphere. Apart from the system of binding rules governing the size and the financing of national budget deficits, decisions on the main components of public policy in such areas as internal and external security, justice, social security, education, and hence on the level and composition of government spending, as well as many revenue measures, would remain the preserve of member states even at the final stage of economic and monetary union.

However, an economic and monetary union could only operate on the basis of mutually consistent and sound behaviour by governments, unions and other economic agents in all member countries. In particular, unco-ordinated and divergent national budgetary policies would undermine monetary stability, generate imbalances in the real and financial sectors of the Community and render it impossible to pursue appropriate macro-economic policies for the Community as a whole. Similarly, strong

(Para. 30, 6th sub-para.) Doyle suggests deletion of this sub-para.

divergences in wage levels, not justified by different trends in productivity, would produce economic tensions and pressures for monetary expansion.

To some extent market forces would exert a disciplinary influence. Financial markets, consumers and investors would respond to differences in macro-economic developments in individual countries and regions, assess their budgetary and financial position, penalise deviations from commonly agreed budgetary guidelines or wage settlements, and thus exert pressure for sounder policies. However, experience suggests that market perceptions do not necessarily provide strong and compelling signals and that access to a large capital market may for some time even facilitate the financing of economic imbalances. Rather than leading to a gradual adaptation of borrowing costs, market views about the creditworthiness of official borrowers tend to change abruptly and result in the closure of access to market financing. The constraints imposed by market forces might either be too slow and weak or too sudden and disruptive. Hence countries will have to accept that sharing a common market and a single currency area imposes policy constraints.

In the general macro-economic field, an overall assessment of the short-term and medium-term economic developments in the Community should be agreed periodically and constitute the framework for a better co-ordination of national economic policies. The Community should be in the position to monitor its overall economic situation, to assess the consistency of developments in individual countries with regard to common objectives and to formulate guidelines for policy.

As regards wage formation and industrial relations, the autonomous negotiating process of social partners should be preserved, but efforts should be made to convince European management and labour of the advantages of gearing wage policies largely to improvements in productivity. Governments, for their part, should refrain from direct intervention in the wage and price formation process.

[In the budgetary field, special arrangements would be necessary. Such arrangements should, firstly, impose effective and binding limits on the size of budget deficits that could be incurred by individual member countries of the Community, although in setting these limits the situation of each member country might have to be taken into consideration. Secondly, the arrangements would have to include strict limits - in terms of both

(Para. 31, 7th sub-para.) <u>Alternative text proposed by Pöhl</u>:
In the budgetary field binding rules are required that would, firstly, impose effective upper limits on budget deficits of individual member countries of the Community; secondly, strictly limit access to direct central bank credit and limit recourse to external borrowing, including borrowing in non-Community currencies. With a view to effective control and

size and of duration - on the maximum permissible access to central bank credit and other forms of monetary financing, as well as on borrowing in non-Community currencies. Thirdly, the arrangements should enable the Community to conduct a coherent mix of fiscal and monetary policies, giving it a set of rules that could be applied in order to determine the aggregate budgetary balance, comprising both the national and the Community positions.]

4. Institutional arrangements

32. Management of the economic and monetary union would call for an institutional framework which would allow policy to be decided and executed at the Community level in those economic areas that were of direct relevance for the functioning of the union. This framework would have to promote efficient economic management, properly embedded in the democratic process. Economic and monetary union would require the creation of a new monetary institution, placed in the constellation of Community institutions (European Parliament, European Council, Council of Ministers, Commission and Court of Justice). The formulation and implementation of common policies in non-monetary fields and the co-ordination of policies under the competence of national authorities would not necessarily require a new institution, but a revision and, possibly, some restructuring of the existing Community bodies could be necessary.

33. A new monetary institution is needed because a single monetary policy cannot result from independent decisions and actions by different central banks. Moreover, day-to-day monetary policy operations cannot respond quickly to changing market conditions unless they are decided centrally. Considering the political structure of the Community and the advantages of making existing central banks part of a new system, the domestic and international monetary policy of the Community should be organised in some federal form and might be called a European System of Central Banks (ESCB). This new System would have to be given the full status of an autonomous Community institution. It would operate in accordance with the provisions of the Treaty, and could consist of a central institution (with its own balance sheet) and the national central banks. At the final stage the ESCB - acting through its Council - would be

co-ordination of market borrowing by public entities at all levels, a "public finance co-ordinating authority" consisting of representatives of all such entities should be established. One of its objectives would be to facilitate the conduct of a coherent mix of fiscal and monetary policies.

responsible for formulating and implementing monetary policy as well as managing the Community's exchange rate policy vis-à-vis third currencies. The national central banks would be entrusted with the implementation of policies in conformity with guidelines established by the Council of the ESCB and in accordance with instructions from the central institution.

The European System of Central Banks should be based on the following principles:

<u>Mandate and functions</u>

- the System would be responsible for the formulation of monetary policy at the Community level and its implementation at the national level, for the full convertibility of European currencies, and for the maintenance of a properly functioning payment system; [the System would have to regulate the amount of money in circulation and the volume of credit supplied by banks and other financial institutions with a view to safeguarding overall price stability;]
- the System would participate in the co-ordination of banking supervision policies of the national supervisory authorities.

<u>Status</u>

- independence of instructions from national governments and Community authorities; this should be ensured by a Treaty provision stating that central bank governors in their position as members of the ESCB Council should act independently of their government;
- proper democratic legitimisation through reporting and appointment procedures;
- appointment of the members of the Board by the European Council on the proposal of the ESCB Council; the tenure of Board members would be for five to seven years and would be irrevocable;
- transmission of an annual report by the ESCB to the European Parliament and the European Council; the Chairman of the ESCB Council could be invited to report to these institutions;

(<u>Mandate and functions</u>, 1st indent) <u>Leigh-Pemberton</u> suggests: "the System would be committed to promoting price stability as ~~well as~~ economic growth".
a basis for sustainable

- supervision of the administration of the System independently of the Community bodies, for example by a supervisory council or a committee of independent auditors.

Structure and organisation

- a federative structure, since this would correspond best to the political structure of the Community;
- establishment of a ESCB Council (composed of the Governors of the central banks and the members of the Board), which would be responsible for the formulation of and decision on the thrust of monetary policy; decisions would be made by weighted majority vote;
- establishment of a Board (with supporting staff), which would monitor monetary developments and oversee the implementation of the common monetary policy;
- national central banks, which would execute operations in accordance with instructions given by the Board.

Policy instruments

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

34. In the economic field, in contrast to the monetary field, an institutional framework for performing policy tasks was already established in the Treaty of Rome, with different and complementary functions conferred on the European Parliament, the Council of Ministers, the Monetary Committee, the Commission and ~~the Court of Justice~~. The new Treaty would therefore not have to determine the mandate, status and structure of a new institution but would have to provide for additional or changed roles for

the existing bodies in the light of the policy functions they would have to fulfil in an economic and monetary union. It would have to specifically define these changes and determine the areas in which decision-making authority would have to be transferred from the national to the Community level.

General criteria

In order to ensure the flexible and effective conduct of policies in those economic areas in which the Community would be involved, several basic requirements would have to be fulfilled:

- where policies were decided and enacted at the Community level, there would have to be a clear distribution of responsibilities among the existing Community institutions, a distinction being made as to whether decisions related to the setting of broad policy directions or to day-to-day operations. By analogy with the structure of the European System of Central Banks, where the ESCB Council would determine the broad lines of monetary policy and the Board would be responsible for the day-to-day execution of these policies, a similar division of responsibilities could be envisaged in the economic field leaving it to the Council of Ministers to determine the broad lines of economic policy, and to the Commission to see to the day-to-day execution of these policies;
- in case of non-compliance by member states, the Commission would have the responsibility for taking effective action to assure compliance; the nature of such action would have to be explored;

[- discretionary changes in Community resources, in the level of harmonised taxation rates and in the terms and conditions attached to structural policies and Community loans should be used as instruments and incentives to support agreed policies.]

Single market and competition policy

In these two areas, the necessary procedures and arrangements have already been established by the Treaty of Rome and the Single European Act, which confer the necessary legislative, executive and judicial authority on the Community. The completion of the internal market will

(General criteria, 3rd indent) Leigh-Pemberton notes that there is no commitment to harmonise tax rates and that it is not clear what institution is supposed to be recommending ...

result in a marked easing of the overall burden of regulation for economic agents, but for the Community institutions it will mean a substantial addition to their executive and policing functions.

Community policies in the regional and structural field

The foundations for a more effective Community role in regional and structural development have recently been established, with both a doubling of the resources of structural funds and a reorganisation of policies as described earlier in this Report. These mechanisms might have to be further extended and made more effective as part of the process leading to economic and monetary union.

Macro-economic policy

The broad objective of economic policy co-ordination would be to promote growth, employment and external balance in an environment of price stability. For this purpose co-ordination would involve defining a medium-term framework for budgetary policy within the economic and monetary union; managing common policies with a view to structural and regional development; determining, in close consultation with the ESCB Council, the Community's exchange rate policy; and participating in policy co-ordination at the international level.

New procedures required for this purpose would have to strike a balance between reliance on binding rules, where necessary, to ensure effective implementation and discretionary co-ordination adapted to particular situations.

In particular it would seem necessary to develop procedures and binding rules for budgetary policy, involving enforceable decisions taken by majority:

- the definition of the overall stance of fiscal policy over the medium term, including the size and financing of the aggregate budgetary balance, comprising both the national and the Community positions;
- limitations on public borrowing, e.g. related to public investment requirements;
- strict limitations on access to central bank credit and other monetary financing;

- strict limitations on borrowing in non-Community currencies.

35. The new Treaty laying down the objectives, features, requirements, procedures and organs of the economic and monetary union would add to the existing Community institutions (European Parliament, European Council, Council of Ministers, Commission and Court of Justice) a new institution of comparable status, the European System of Central Banks. With due respect for the independent status of the ESCB, as defined elsewhere in this Report, appropriate consultation procedures would have to be set up to allow for effective co-ordination between budgetary and monetary policy. To this end, attendance by the President of the Council and the President of the Commission at meetings of the ESCB Council, without power to vote or to block decisions taken in accordance with the rules laid down by the ESCB Council, would have to be provided for. Equally, attendance by the Chairman of the ESCB Council at meetings of the Council of Ministers would have to be provided for, especially on matters of relevance to the conduct of monetary policy. Consideration would have to be given to the role of the European Parliament, especially in relation to the authority devolving on the Commission in budgetary matters, where the latter should be accountable to the European Parliament. The same should apply in regard to action taken by the Commission, or its non-action, in response to a member country's non-compliance with binding rules or decisions, especially in the budgetary field.

5. Economic and monetary union in the context of the world economy

Leigh-Pemberton suggests omitting the section on "Economic and monetary union in the context of the world economy".

36. The realisation of an economic and monetary union would give the Community a more important say in international negotiations and enhance its capacity to influence the relations among industrial and developing countries in a wide range of areas such as trade policies, international monetary matters, macro-economic policy concertation and the North-South dialogue.

37. The responsibility for external trade policy has been assigned to the Community in the Treaty of Rome, and the Commission, acting as the Community's spokesman, represents all the member countries in multilateral trade negotiations. This role will be strengthened with the completion of

the single market, which has the potential to stimulate multilateral trade and economic growth at the global level. However, this potential can only be exploited to the full in an open trading system, which guarantees foreign suppliers free access to the Community market and, conversely, guarantees exporters from the Community free access to foreign markets. The removal of internal trade barriers within the Community should constitute a step towards a more liberal trading system on a worldwide scale.

38. The creation of a single currency area and, concomitantly, the move to a single monetary policy conducted by the European System of Central Banks will change the role of the Community in international monetary matters. The Community would have to assume increasing responsibility for international monetary developments, both as regards short-term co-operation between central banks in interest rate management and exchange market interventions and in the search for solutions to issues relating to the further development of the international monetary system.

39. As economic and monetary union necessitates an effective macro-economic management for the Community as a whole, it would also strengthen the Community's position in the process of international policy concertation among major industrial countries. However, for the Community to play its part in this respect, the arrangements for internal macro-economic policy formulation and implementation would have to be sufficiently flexible, allowing the Community not only to respond effectively to changing circumstances in its internal economic situation, but also to be able to co-ordinate policies in a manner satisfactory to both the Community and other major industrial countries.

40. The institutional arrangements which would enable the Community to fulfil the new responsibilities implied by its increased weight in the world economy are partly in place or would be implemented in the process of creating an economic and monetary union. In the area of external trade policies and, to some extent, in the field of co-operation with developing countries, the responsibilities have already been attributed to the Community. With the establishment of the European System of Central Banks the Community would also have created an institution through which it could participate in all aspects of international monetary management. As far as

macro-economic policy co-ordination at the international level is concerned, the Community as such is currently represented only at the summit meetings of the major industrial countries. In order to make full use of its position in the world economy and to exert influence on the functioning of the international economic system, the Community would have to be able to speak with one voice. This emphasises the need for an effective mechanism for macro-economic policy co-ordination within the economic and monetary union.

III. **Steps towards economic and monetary union**

41. After defining the main features of an economic and monetary union, the Committee has undertaken the "task of studying and proposing concrete stages leading towards this union". The Committee agreed that the creation of economic and monetary union must be viewed as a single process. Although set out in stages which guide the progressive movement to the final objective, the decision to enter the first stage should be a decision to embark on the entire process. ~~The implementation of the concrete measures proposed for stage one should be supported by the conclusion of a new Treaty.~~

At the end of this Part the procedure to be followed for the further elaboration of economic + monetary union are suggested.

[A firm political commitment to the creation of economic and monetary union, as described in Part II of this Report, would appear to be an indispensable precondition for lending credibility to the decision to embark on the first stage. The decision by the highest political authorities to enter into negotiations concerning the drafting of a new Treaty would be the strongest expression of such a commitment.]

1. Principles governing a step-by-step approach

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

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

44. Parallelism. As has been argued in Part II, monetary union without a sufficient degree of convergence of economic policies is unlikely

(Para. 41, 2nd sub-para.) Leigh-Pemberton suggests redraft of second sub-para. of para. 41:

On the other hand, a clear political commitment to the final stage, as described in Part II of the Report, would lend credibility to the intention that the measures which constitute stage one should represent not just a useful end in themselves but a firm first step on the road towards economic and monetary union. The clearest demonstration of such a political commitment would be the co-ordinated implementation of economic policy measures in each member state to secure price stability and convergence of economic performance within the existing institutional framework and the full participation of all member states in the exchange rate mechanism of the EMS. Given that background commitment by the political authorities~~, in good time before entering stage two~~, to enter into the negotiation of a new Treaty ~~would have added significance~~. would ensure the continuity of the process.

(Para. 41, last sentence) Hoffmeyer (supported by Doyle) suggests replacing last sentence of para. 41 by:

It would be a strong expression of such a commitment if all members of the Community became full members of the EMS in the course of stage one and undertook the obligation to formulate a convergent economic policy within the existing institutions. Similarly, it would be highly significant if the political authorities in good time before entering stage two committed themselves to enter into negotiations of a new Treaty.

(Para. 41, 2nd sub-para.) de Larosière suggests amending the last sentence to read: "... to enter immediately into negotiations ...".

to be durable and could be damaging to the Community. Parallel advancement in economic and monetary integration would be indispensable to avoid imbalances which could cause economic strains and loss of political support for further developing the Community into an economic and monetary union. Perfect parallelism at each and every point of time would be impossible and could even be counterproductive. Already in the past the advancement of the Community in certain areas has gone hand in hand with temporary standstill in others, thus involving only partial parallelism. Some temporary deviations from parallelism ~~is~~ part of the dynamic process of the Community. But bearing in mind the need to achieve a substantial degree of economic union if monetary union is to be successful, and given the degree of monetary co-ordination already achieved, it is clear that material progress on the economic policy front is necessary for further progress on the monetary policy front. Parallelism would have to be maintained in the medium term and also before proceeding from one stage to the next. are

45. Calendar. The conditions for moving from stage to stage cannot be defined precisely in advance; nor is it possible to foresee today when these conditions will be realised. The setting of explicit deadlines is therefore not advisable. This observation applies to the passage from stage one to stage two and, most importantly, to the move to irrevocably fixed exchange rates. The timing of both moves would involve an appraisal by the Council ~~the Commission~~ ~~and~~ the European System of Central Banks in the light of the experience made in the preceding stage. However, there should be a clear indication of the timing of the first stage, which should start no later than 1st July 1990 when the Directive for the full liberalisation of capital movements comes into force.

46. Participation. There is one Community, but not all the members have participated fully in all its aspects from the beginning. [A consensus on the final objectives of the Community, as well as participation in the same set of institutions, should be maintained, while allowing for a degree of flexibility concerning the date and conditions on which some member countries would join certain arrangements. Pending the full participation of all member countries - which is of prime importance - the ~~management~~ of each set of arrangements would have to be ~~the responsibility of~~ those who

Countries

(Para. 46) Alternative text proposed by Leigh-Pemberton:
The Committee therefore considered ~~the~~ possibility that some member states might take institutional steps in the direction of EMU before others were able to do so. It formed the unanimous opinion that any such discriminatory approach, which would in any event have to be outside the framework of the Treaty of Rome, would be divisive and ~~would~~ put at risk the existing fabric of the European Communities.

participate fully in it. However, this management would have to keep in view the need to facilitate the integration of the other members.]

2. The ECU

47. The Committee investigated various aspects of the role that the ECU might play in the process of economic and monetary integration in Europe.

48. Firstly, the Committee examined the role of the ECU in connection with an eventual move to a single currency. Although a monetary union does not necessarily require a single currency, ~~political and psychological~~ reasons suggest that ~~a single currency~~ would be a desirable feature of a monetary union. The Committee was of the opinion that the ECU has the potential to be developed into such a common currency. This would imply that the ECU would be transformed from a basket of currencies into a genuine currency. ~~Private agents should be assured that~~ there would be no discontinuity between the ~~present~~ ECU and the single currency of the union and that ECU obligations would be payable at face value in ECU if the transition to the single currency had been made at the time of the maturity of the contract.

good

49. Secondly, the Committee considered the possibility of adopting a parallel currency strategy as a way to accelerate the pace of the monetary union process. According to this approach the definition of the ECU as a basket of currencies would be abandoned at an early stage and the new fully-fledged currency, called ECU, would be created autonomously and issued in addition to the existing Community currencies, competing with them. The proponents of this strategy expect that the gradual crowding-out of national currencies by the ECU would make it possible to circumvent the institutional and economic difficulties of establishing a monetary union. The Committee felt that this strategy was not to be recommended for ~~two~~ [three] main reasons. Firstly, an additional source of money creation without a precise linkage to economic activity could jeopardise price stability. Secondly, the addition of a new currency, subject to an independent monetary policy, would further complicate the already difficult endeavour of co-ordinating different national monetary policies.

(Para. 46) Doyle suggests inserting before the sentence starting with "Pending ..." the following text:
Nevertheless, an undertaking to participate in the exchange rate mechanism of the EMS ~~by a specified date~~ should be given at the time when member states formally commit themselves to the objective of economic and monetary union.

(Para. 48) Ciampi: notes that at the February meeting agreement had been reached on the formulation "the ECU should develop ..." instead of "the ECU has the potential to develop ..."

This irrevocable fixing of exchange rates would - implying that

~~submitted to the Committee~~

50. Thirdly, the Committee examined possibilities for using the official ECU as an instrument in the conduct of a common monetary policy. The main features of possible schemes are described in the Collection of Working Papers, which represent personal contributions to the Committee. A ~~number of members of the Committee felt that such proposals might be possible ways of preparing the ground for a~~ common monetary policy in the course of the second stage. ~~Other members of the Committee felt these schemes were neither adequate nor appropriate as a solution to the problem of ensuring equivalent monetary policies in the diverse monetary frameworks of the member states.~~

51. Fourthly, the Committee agreed that there should not be discrimination against the ~~voluntary~~ private use of the ECU ~~by the private sector~~ and that existing administrative obstacles should be removed.

3. The principal steps in stage one

52. Stage one represents the entry into the process of creating economic and monetary union. It would aim at a greater convergence of economic performance through the strengthening of economic and monetary policy co-ordination within the existing institutional framework. ~~[It would involve the preparation and ratification of a new Treaty which would provide the necessary basis for implementing stage two.]~~

(Para. 52, last sentence) Leigh-Pemberton suggests deletion or redrafting: "In the institutional field, by the time of transition to stage two, it would be necessary to have prepared and ratified the Treaty".
~~Pöhl suggests adding at the end:~~
"at a time to be decided in the light of progress made in the integration process in stage one".

53. In the economic field the steps would centre on the completion of the internal market and the reduction of existing disparities through programmes of budgetary consolidation for countries concerned and more effective structural and regional policies. In particular, there would be action in three directions.

Firstly, there would be a complete removal of physical, technical and fiscal barriers within the Community, in line with the internal market programme. The completion of the internal market would be accompanied by a strengthening of Community competition policy.

Secondly, the reform and doubling of the structural funds would be fully implemented in order to enhance the ability of Community policies to promote regional development and to correct economic imbalances.

Thirdly, the 1974 Council Decision on economic convergence would be replaced by a new procedure that would strengthen economic and fiscal policy co-ordination and would, in addition, provide a comprehensive framework for an assessment of the consequences and consistency of the overall policies of member states. On the basis of this assessment, recommendations would be made aimed at achieving a more effective co-ordination of economic policies, taking due account of the views of the Committee of Governors. The task of economic policy co-ordination should be the primary responsibility of the Council of Economic and Finance Ministers (ECOFIN). ~~whose discussions would be prepared by the Monetary Committee, the Committee of Governors and the Commission~~. Consistency between monetary and economic policies would be facilitated by the attendance of ~~central bank Governors~~ the Chairman of the Committee of Central Bank Governors at appropriate Council meetings. In particular, the revised 1974 Decision on convergence would:

- establish a process of multilateral surveillance of economic developments and policies based on agreed indicators. Where performances were judged inadequate or detrimental to commonly set objectives, policy consultations would take place at the Community level and recommendations would be formulated with a view to promoting the necessary corrections in national policies;
- set up a new procedure for budgetary policy co-ordination, with increasingly precise quantitative guidelines and medium-term orientations;
- provide for ~~the possibility of promoting, where deemed appropriate,~~ concerted budgetary action by the member countries.

54. In the monetary field the focus would be on removing all obstacles to financial integration and intensifying co-operation and co-ordination of monetary policies. In this connection consideration ~~could~~ sh~~ould~~ be given to extending the scope of central banks' ~~independent actions.~~ autonomy. Realignments of exchange rates would still be possible, but an effort would be made by every country to make the functioning of other adjustment mechanisms more effective. Actions would develop along several lines.

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

Secondly, [it would be important to include all Community currencies in the EMS exchange rate mechanism.] The same rules would apply to all the participants in the exchange rate mechanism.

Thirdly, all impediments to the private use of the ECU would be removed.

Fourthly, the 1964 Council Decision defining the mandate of the Committee of Central Bank Governors would be replaced by a new Decision giving the Committee greater prominence and a stronger voice in the economic policy-making process of the Community and its member states. To this end, ~~the Committee of Governors would~~:

- formulate opinions on the overall orientation of monetary and exchange rate policy, as well as on measures taken in these fields by individual countries. In particular, the Committee would be consulted in advance of national decisions on the course of monetary policy, such as the setting of annual domestic monetary and credit targets;
- express policy opinions to individual governments and the Council of Ministers on policies that could affect the internal and external monetary situation in the Community, especially the functioning of the EMS. The outcome of the Committee's deliberations could be made public by the Chairman of the Committee;
- submit an annual report on its activities and on the monetary situation of the Community to the European Parliament and the European Council;

The Committee's opinions would not have to reflect unanimity and would not be binding. In order to make its policy co-ordination function more effective, the Committee would appropriately strengthen the research and advisory role of three sub-committees and provide them with a permanent research staff:

- a monetary policy committee would define common surveillance ~~instruments~~ indicators, propose harmonised objectives and instruments and help to gradually bring about a change from ex post analysis to an ex ante approach to monetary policy co-operation;

normally

(Para. 54, 3rd sub-para.) Pöhl and Doyle suggest rephrasing the sentence between brackets:
"all Community currencies should be included in the EMS exchange rate mechanism".

The Committee suggests that the Committee of Central Bank Governors should:

consider ways of enhancing the role of the Chairman.

- a foreign exchange policy committee would monitor and analyse exchange market developments and assist in the search for effective intervention strategies;
- an advisory committee would hold regular consultations on matters of common interest in the field of banking supervision policy.

55. A number of Committee members advocated the creation of a European Reserve Fund (ERF) that would foreshadow the future European System of Central Banks. The main objectives of the ERF would be:

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

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

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

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

The management of the ERF would consist of:

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

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

- too much emphasis is placed on external considerations; common interventions by such a Fund cannot be a substitute for economic adjustment to correct imbalances within the Community;
- the proposal involves an institutional change which, in accordance with Article 102A of the amended Treaty of Rome, would fall under the procedure stipulated in Article 236 and require a new Treaty; the setting-up of a Fund under the same procedures as were applied to the establishment of the EMS is not considered possible;
- they consider that some functions of the Fund could be performed by the Committee of Governors if it were given wider powers; thus, there is no need to set up a new institution immediately;
- what, in the view of these members, is essential is co-ordination of intervention policies rather than the technique of common interventions. This co-ordination can provide the necessary training ground while avoiding the unnecessary complication of instituting an additional intervention window.

4. The principal steps in stage two

57. The second stage could begin only when the new Treaty had come into force. In this stage the basic organs and structure of the economic and monetary union would be set up, involving both the revision of existing institutions and the establishment of new ones. The institutional framework would gradually take over operational functions, serve as the centre for monitoring and analysing macro-economic developments and promote a process of common decision-making, involving certain operational decisions made by majority. Stage two must be seen as a period of transition to the final stage and would thus primarily constitute a training process leading to collective decision-making without yet abandoning the ultimate responsibility for policy decisions at the national level. The precise operating procedures to be applied in stage two would be developed in the light of the prevailing economic conditions and the experience gained in the previous stage.

58. In the economic field, the European Parliament, the Council of Ministers, the Monetary Committee and the Commission would reinforce their action along three lines.

Firstly, in the area of the single market and competition policy the results achieved through the implementation of the single market programme would be reviewed and, wherever necessary, be consolidated.

Secondly, the performance of structural and regional policies would be evaluated ~~and a new programme would be adopted.~~ The resources for supporting the structural policies of the member states ~~would be~~ enlarged. Community investment programmes in research and infrastructure would be strengthened.

, if necessary, be

and adapted in the light of experience.

might have to

Thirdly, in the area of macro-economic policy, the procedures set up in the first stage through the revision of the 1974 Decision on convergence would be further strengthened and enlarged on the basis of the new Treaty. Policy guidelines would be adopted by majority decision. On this basis the Community would:

- set a medium-term framework for key economic objectives aimed at achieving stable growth with a follow-up procedure for monitoring performances and intervening when significant deviations occurred;

- set progressively more precise - although not yet binding - rules relating to the size of budget deficits and their financing; the Commission should be responsible for bringing to the Council any instance of non-compliance by member states and should propose action as necessary;
- assume a more active role as a single entity in the discussion of questions arising in the economic and exchange rate field, on the basis of its present representation (through the member states or the Commission) in the various fora for international policy co-ordination.

59. In the monetary field the most important feature of this stage would be that the European System of Central Banks would be set up and would absorb the previously existing institutional monetary arrangements (the EMCF, the Committee of Governors, the sub-committees for monetary policy analysis, foreign exchange policy and banking supervision, and the permanent Secretariat). The functions of the ESCB in the formulation and operation of a common monetary policy would gradually evolve as experience was gained. Some possible schemes for co-ordinating monetary policies in the course of this stage are discussed in the Collection of Working Papers. Exchange rate realignments would not be excluded as an instrument of adjustment, but there would be an understanding that they would be made only in exceptional circumstances and that the frequency and the extent of realignments should be steadily reduced.

Initially the ESCB framework could be used in the following ways: as a joint facility to be shared by national central banks for implementing national monetary policy through operations in domestic and foreign exchange markets; as a centre for monitoring and analysing domestic monetary conditions and foreign exchange market developments; and as a centre for the co-ordination of national monetary policies.

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

Firstly, general monetary targets would be set for the Community as a whole, with an understanding that national monetary policy would be executed in accordance with these global guidelines. The general monetary targets would be set by the ESCB Council by majority decision.

- 35 -

new text

(Para. 59, 3rd sub-para.) Pöhl suggests complete deletion of the rest of the paragraph (starting with "In addition, ...").

(Para. 59, 3rd sub-para.) Thygesen (supported by Ciampi) suggests redraft starting with "In addition, ..."):

In addition, a certain number of actions would be taken in stage two. They would be designed to give the new institution visible means of influencing the overall rate of money and credit expansion in the participating countries as well as the ability to conduct limited exchange market interventions against third currencies. They would also comprise the attribution of regulatory functions to the ESCB in the monetary and banking field in order to achieve minimum harmonisation of provisions such as reserve requirements or payments arrangements that are necessary to the conduct of a common monetary policy.

Intermediate monetary objectives would be set for the Community as a whole, derived from the ultimate objective of medium-term price stability, and underpinned by objectives for national contributions to aggregate money creation and a presumption that participating central banks would refrain from offsetting the monetary consequences of interventions in other participating currencies.

Incentives for individual central banks to stay close to commonly agreed objectives would be provided through a mechanism which would sanction deviations. This could be done most directly and with the prospect of gradual evolution towards collective monetary control in stage three, by linking the money creation by each central bank to its ability to satisfy reserve requirements vis-à-vis the ESCB in analogy to one method by which national central banks exert influence on the rate of credit expansion of their banking system.

Various methods of applying such a system to the capacity of national central banks to create money are explored as illustrations in the Annex. They all rest on the basic notion that the ESCB would be in a position to control fully the supply of the asset which the central banks have to hold to meet the reserve requirements. This asset could take the form of a unit, defined as the present ECU; it would be supplied by the ESCB in quantities matching the demand for reserves which would arise, if each country followed its collectively targeted rate of money or credit expansion. The interest rate on the reserve asset would reflect the degree of scarcity of required reserves which the ESCB wishes to produce. The system might subsequently be extended to apply to individual banks, but in stage two could be confined to the relationship between the ESCB and the central banks.

The advantage of attributing an instrument of this type to the ESCB is that it would give focus to the operational efforts of the new institution. It would introduce in a limited, but significant sphere, a hierarchy in the relations of the ESCB to the component central banks while respecting the autonomy of the latter in managing their respective short-term instruments to preserve interest differentials conducive to exchange market stability.

Secondly, while the ultimate responsibility for monetary policy decisions would remain with national authorities, the operational framework necessary for deciding and implementing a common monetary policy would be created and experimented with. In this context, for example, the ESCB could issue reserve instruments on the basis of a majority decision. Under such an experimental scheme the minimum reserve requirement would not be compulsory.

[Thirdly, a certain amount of exchange reserves would be pooled and would be used to conduct limited exchange market interventions in accordance with guidelines established by the ESCB Council. Such guidelines would be determined by majority voting according to rules to be specified.]

(Para. 59, 4th sub-para.) Duisenberg suggests the deletion of the sub-para. between brackets (starting with "Thirdly, ...").

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

Fifthly, the margins of fluctuation within the exchange rate mechanism would be narrowed as a move towards the final stage of the monetary union, in which they would be reduced to zero.]

5. The principal steps in stage three

60. The final stage would commence with the move to irrevocably locked exchange rates and the attribution to Community institutions of the full monetary and economic competences described in Part II of this Report. In the course of the final stage the national currencies would ~~eventually~~ be replaced by a single Community currency.

61. In the economic field the transition to this final stage would be marked by three developments. might need to

Firstly, there ~~would~~ be a further strengthening of Community structural and regional policies. Instruments and resources would be adapted to the needs of the economic and monetary union.

Secondly, the rules and procedures of the Community in the macro-economic and budgetary field would assume a binding character.

In particular, the Council of Ministers ~~and the Commission~~, in co-operation with the European Parliament, would have the authority to take directly enforceable decisions, i.e.:

- to impose constraints on national budgets to the extent to which this would be necessary to prevent imbalances that may threaten monetary stability;
- to make 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;
- ~~to decide discretionary changes (through a procedure to be defined) in the level of harmonised taxation rates;~~
- to apply to existing Community structural policies and to Community loans (as a substitute for the present medium-term loans facility) terms and conditions that prompt member countries to intensify their adjustment efforts.

Thirdly, the Community would assume its full role in the process of international policy co-operation and a new form of representation in arrangements for international policy co-ordination and in international monetary negotiations would be adopted.

62. <u>In the monetary field</u> the irrevocable locking of exchange rates would come into effect and the transition to a single monetary policy would be made, with the ESCB assuming all its responsibilities as foreseen in the Treaty and described in Part II. In particular:

- concurrently with the announcement of the irrevocable fixing of parities between the Community currencies, the responsibility for the formulation and implementation of monetary policy in the Community would be transferred to the ESCB, with its Council and Board exercising their statutory functions;
- decisions on exchange market interventions in third currencies would be made on the sole responsibility of the ESCB Council in accordance with Community exchange rate policy; the execution of interventions would be entrusted either to national central banks or to the European System of Central Banks;
- reserves would be pooled and managed by the ESCB
- technical and regulatory work would be done to prepare the transition to a single Community currency.

The change-over to the single currency would take place during this stage.

6. One or several Treaties

63. Legal basis. The Committee has examined the scope for progress in economic and monetary integration under the present legal provisions in force in each member country. This investigation has shown that under present national legislations no member country is able to transfer decision-making power to a Community body, nor is it possible for many countries to participate in arrangements for a binding ex ante co-ordination of policies. [Steps, permitting collective decision-making - even on more limited operational matters - would involve changes in the institutional framework and, as has been pointed out earlier in this Report, necessitate a new Treaty.]

new text

64. The Committee has not investigated in detail the possible approaches under which the objective of economic and monetary union and its implementation would be embodied in the new Treaty. There would be basically two options. One procedure would be to conclude a new Treaty for each stage. The advantage of this procedure would be that it would explicitly reaffirm the political consensus at each stage and would allow for modification of the form the following stage should take in the light of experience with the current stage. At the same time, this approach ~~would be~~ might prove unwieldy and slow, it might not safeguard sufficiently the overall consistency of the process and it ~~would~~ might carry the risk that parallel progress on the monetary and non-monetary sides would not be respected. In any event, if this procedure were chosen it would be crucial that the first Treaty laid down clearly the principal features of the ultimate objective of economic and monetary union.

65. Alternatively, it could be decided to conclude a single comprehensive Treaty formulating the essential features and institutional arrangements of economic and monetary union and the steps in which it could be achieved. Such a Treaty should indicate the procedures by which the decision would be taken to move from stage to stage. Each move would

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not major

major incremental

Para. 63 is a redraft of para. 50, in the 2nd March version of the Report. Alternative text for old para. 50 suggested by Andriessen:

The Treaty

The Treaty of Rome, as amended by the Single Act lays down the basis for progress towards EMU. It is, however, insufficient for full realisation of EMU. There is at present no transfer of responsibility for economic and monetary policy from member states to the Community. The rules governing the EMS are based on ~~informal~~ agreements ~~of self-restriction by~~ between the central banks concerned and are not an integral part of Community legislation. Without a new Treaty, steps towards EMU will be limited to non-binding co-ordination and strengthened co-operation. The process of integration based on a step-by-step approach requires, however, a clear understanding of its content and final objective, its basic functional and institutional arrangements and the provisions governing the gradual implementation. A new political and legal basis is accordingly needed, ~~from the outset~~. A new Treaty would establish not only the objective but also the stages by which it is to be achieved and the procedures and institutions required to move forward at each stage. Within this framework, the moves forward would take place on the basis of joint appraisals and assessments at each stage along the way. Political agreement would be required for each move to be implemented.

A new Treaty is also required to ensure parallel progress in the economic and in the monetary fields. The appropriate institutional and procedural arrangements to that effect should also be set out in the Treaty.

(Para. 63) Pöhl suggests redraft (on the basis of old para. 50) of the last sentence in brackets, to become a new paragraph:

As a consequence, one approach would be to provide for new concrete steps towards economic and monetary union that would initially be confined to measures designed to strengthen co-operation, mutual surveillance, analysis of current developments and prospects, and non-binding co-ordination of policies until such time when preparation and ratification of a new Treaty is considered appropriate. In the monetary field, the Committee of Central Bank Governors should be called upon to proceed accordingly; in the economic field, the existing Community institutions would be instructed likewise. A new Directive by the Council would define the objectives to be pursued and the detailed steps to be taken without institutional change.

require an appraisal of the situation and a decision by the European Council.

7. Suggested follow-up procedure

66. If the European Council can accept this Report as a basis for the further development towards economic and monetary union, the following procedure is suggested.

67. The Council and the Committee of Governors are invited to take the decisions necessary to implement the first stage.

68. The competent Community bodies are invited to make concrete proposals on the basis of this Report concerning the second and the final stage, to be ~~subsequently~~ embodied in a revised Treaty. These proposals should contain a further elaboration and concretisation where necessary of the present Report. They should serve as the basis for future negotiations on a revised Treaty in an intra-governmental conference to be called by the European Council.

~~69. In following this procedure,~~ negotiations on a revised Treaty will take place on a basis which will [already have been agreed as far as possible in substance by] those immediately responsible in member countries. At the same time, progress in policy co-ordination in the first stage as well as implementation of the internal market is allowed to create a momentum favourable for the negotiations.

~~70. The decision to bring the revised Treaty into force will be taken with due regard to the results achieved in the first stage.~~

Preparatory work for the negotiation on the new Treaty would start immediately.

(Section 7) Text proposed by Duisenberg (a very similar proposal has also been made by Pöhl).

(Paras. 68-69) Ciampi proposes to amend these paras. to make the procedures more direct.

(Para. 68) de Larosière suggests redraft:

Simultaneously it is decided to launch a negotiation on a revised Treaty in an intra-governmental conference to be called by the Heads of State. In the framework of this negotiation, the competent Community bodies will make concrete proposals on the basis of this Report concerning the second and the final stage. These proposals will be embodied with the appropriate legal considerations in the revised Treaty.

(Para. 69) de Larosière suggests replacing the part in brackets by "involve".

(Para. 70) Ciampi suggests omission.

Annex I

Excerpts from the Conclusions of the Presidency presented after the meeting of the European Council in Hanover on 27th-28th June 1988

5. Monetary union

The European Council recalls that, in adopting the Single Act, the member states confirmed the objective of progressive realisation of economic and monetary union.

They therefore decided to examine at the European Council meeting in Madrid in June 1989 the means of achieving this union.

To that end they decided to entrust to a Committee the task of studying and proposing concrete stages leading towards this Union.

The Committee will be chaired by Mr. Jacques Delors, President of the European Commission.

The Heads of State and Government agreed to invite the President or Governor of their central banks to take part in a personal capacity in the proceedings of the Committee, which will also include one other member of the Commission and three personalities designated by common agreement by the Heads of State or Government. They have agreed to invite:

- Mr. Niels Thygesen, Professor of Economics, Copenhagen;
- Mr. Lamfalussy, Director-General of the Bank for International Settlements in Basle, Professor of Monetary and Economics at the Catholic University of Louvain-la-Neuve;
- Mr. Miguel Boyer, President of "Banco Exterior de España".

The Committee should have completed its proceedings in good time to enable the Ministers for Economic Affairs and for Finance to examine its results before the European Council meeting in Madrid.

Annex II

List of members of the Committee

Jacques Delors (Chairman)
Frans Andriessen
Miguel Boyer
Demitrius J. Chalikias
Carlo Azeglio Ciampi
Maurice F. Doyle
Wim F. Duisenberg
Jean Godeaux
Erik Hoffmeyer
Pierre Jaans
Alexandre Lamfalussy
Jacques de Larosière
Robert Leigh-Pemberton
Karl Otto Pöhl
Mariano Rubio
José A.V. Tavares Moreira
Niels Thygesen

Rapporteurs:

Gunter D. Baer
Tommaso Padoa-Schioppa