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September 26, 1988

Dear Gunter, Jean Paul, Joly,

I hope these proposed amendments are readable. We shall discuss them tomorrow, when I may come with a few additional proposals.

As you see I have inserted a few questions on Section I. It seems to me that this is the only way not to preempt the discussion about "how much" EU is necessary for an MU.

Best regards

Tommaso,

Tommaso Padoa-Schioppa

COMMENTS AND REDRAFTS

- Most of my comments are manuscript on the margin of the text

- Section III.1 contains questions on the features of a monetary union. I think it is appropriate that the Lux. meeting should devote some time to such questions. III.1 However, contrary to all the other parts of the paper, such questions are not preceded by any analysis of the issues. Should we at least announce (e.g. on p.2) such questions? Or should we put them in a separate note of one page (something like: "Preliminary discussion of the features of a MU")?

- The Finanzausgleich mechanism is presented as a way to deal with changes in competitiveness (pp.3-4) rather than as a remedy to disparities in the level of economic development. I have doubt about this presentation, although I have not proposed any amendment.

- Insert A (p.4)

...... shifts of demand away from less competitive to more competitive regions.

It may be argued that in the absence of the possibility to alter exchange rate relations such changes would not occur or would occur only in a limited way. Furthermore, it may be through that the adjustment of these imbalances will be brought about by market mechanisms operating through changes in relative wages, movements of labour and, possibly, induced compensatory private capital flows. For instance, there would be a tendency for wages to decline in, and labour to emigrate from, those regions where relative competitiveness has declined.

On the contrary, it may be argued that, given the downward rigidity of wages and the continued existence of non-economic barriers to labour mobility, adjustment might not take place smoothly and could leave intolerable disparities in the level of output and employment between different regions of the Community. In order to avoid major dislocations and to mitigate adjustment burdens, a system of compensatory financing involving movements of funds from more competitive to less competitive regions might therefore be needed.

Flows of investment capital and private transfers could be expected to produce some of the necessary offsetting movements of funds. However, to the extent that private flows did not suffice to reduce significantly income disparities they might - possibly for a fairly long period of time - have to bo supplemented by financial transfer payments through official channels, i.e. through national budget.

The Committee may want to discuss

- the extent to which changes in competitiveness are likely to be dampened in a monetary in a monetary union

- the possibility to resolve competitive disequilibria through market adjustment

- the need for special (transfer or other) policy instrument to supplement market induced adjustment.

- Insert B (p.5)

...... fiscal policies tend to give rise to exchange rate pressures and may thereforo constrain national fiscal policies insofar as countries resist to such pressures in order to avoid a change in parity.

It may be argued that in a monetary union, with exchange rates irrevocably fixed, sufficient discipline will be imposed upon national budgets, first, by the impossibility to finance fiscal deficits with central bank credit, and, second, by the impossibility to secure priviledged access to the national capital market. This view regards fiscal divergencies as a rather remote danger for the union.

On the contrary, it may be argued that market's assessment of an excessively expansionary (or restrictive) fiscal policy expressed only in the form of different risk premia (i.e. divergent interest rates on similar types of government securities), reflecting the markets' changing perceptions of the borrower's creditworthiness would not exert sufficient discipline nor funtion smoothly. Rather than differentiating gradually between the quality of different borrowers, the markets' assessment tends to alter abruptly and major disruptions may occur in financial markets as borrowers find themselves suddenly shut off from access to private credit markets.

The Committee may wish to discuss these alternative views of the implications of a monetary union for fiscal and budgetary policies. Depending of the assessment of the consequences of a monetary union in combination with an unrestricted internal market the need for a number of functional and institutional arrangements in non-monetary areas of economic policy-making may be felt more or less strongly by the Committee.

- Insert C (pp.7-8)

In conclusion, monetary union reduces costs of transactions and removes oxchange rate uncertainties, eliminates coompetitive distortions and macroeconomic disturbances stemming from exchange rate changes unwarranted by fundamental economic conditions. It therefore represents an important prerequisite for reaping the full benefit of an enlarged market in which goods, services and factors of production can move freely. At the same time monetary union would imply giving up exchange rate changes as an instrument of adjustment. Some may consider that the monetary union will by itself impose a large degree of convergence on fiscal and wage behaviour and think that residual divergencies will be adjusted through market mechanisms. Others do not share this view and consider that monetary union requires arrangements ensuring a close co-ordination of various non-monetary policies. According to this view, complementary measures in the field of fiscal and budgetary policies, social policies and a range of micro-economic policies are indispensable because without such measures there would be a serious danger that major adjustment problems would jeopardise the maintenance of the monetary union.

- Insert D

To what extent is a joint fiscal policy necessary for a monetary union to function effectively? Can a monetary union be accompanied - on the budgetary side - only by "soft" coordination procedures such as those that are in place today?

If the formulation of a joint fiscal policy was considered to be necessary, on what criteria would it be based? How would the overall objective be defined and how would it be translated into measurable targets?

26.9.88

22nd September 1988

Draft

Some implications of a monetary union

A note for discussion

Introduction

The Resolution of the Council and the Representatives of the Governments of the Member States of 22nd March 1971 states that at the conclusion of the process of economic and monetary integration the Community will:

1. Constitute an area within which persons, goods, services and capital may move freely and without distortion of competition, without, however, giving rise to structural or regional imbalances, under conditions permitting economic activity to expand on a Community scale;

2. Form a single currency area within the international system, characterized by the total and irreversible convertibility of currencies, the elimination of margins of fluctuation of exchange rates, the irrevocable locking of parities - all of which are essential preconditions for the creation of a single currency - and including a Community organization of the central banks;

3. Possess such powers and responsibilities in economic and monetary matters as will enable its institutions to administer the union. To this end the requisite decisions on economic policy shall be taken at Community level and the necessary powers shall be conferred upon the institutions of the Community.

The purpose of this note is to investigate the requirements that might have to be fulfilled in an economic union[1] if a monetary union as defined in the 1971 Resolution is established. In examining this

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1. As discussed in the accompanying note on "...", economic union is understood to encompass an area in which the free movement of persons, goods, services and capital is complemented by social measures and technical and environmental co-operation across national borders.

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relationship the note assumes that monetary union is in place and thus solely focuses on the question of what kind of arrangements might be needed in non-monetary areas to ensure a satisfactory economic management and performance in the Community. The note does not address questions relating to the desirability of setting up a monetary union, nor does it deal with practical steps and stages on the way to monetary union. However, in order to provide some factual background information the note contains a brief description of elements of economic and monetary union that were in place on the eve of the Single European Act and of those elements that are expected to be implemented by the end of 1992.

Accordingly, the note is organised in three main sections: the first one spells out the principal characteristics of monetary union and the implications for economic management; the second section briefly describes the state of economic and monetary integration at end-1985 and the progress expected to be made until end-1992; a final section draws some broad conclusions and raises a number of issues for discussion.

I. Elements describing monetary union and the implications for economic union

1. Monetary Union: characteristics

In accordance with the definition presented in the Werner Report and in the 1971 Resolution quoted above, monetary union is characterised by:

- a single currency area, implying total and irreversible convertibility of currencies, the elimination of fluctuations of exchange rates and the irrevocable locking of parities;
- complete liberalisation of capital transactions and full integration of banking and other financial markets.

From these characteristics it follows that in a monetary union:

- there can be only one monetary policy for the Community as a whole;
- that decision-marking in the field of monetary policy will be a collective undertaking;
- that ~~[illegible]~~ institutional and legal changes both national and Community levels.

? are necessary at

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In conjunction with the establishment of a common unrestricted market, a monetary union implies that:

- the irrevocable locking of exchange rate policies will reduce transactions costs and remove exchange rate uncertainties;
- the international weight of the Community in transactions with the rest of the world will be increased and the Community's susceptibility to external stocks will be lessened;
- the exchange rate will cease to be a policy instrument for the adjustment of economic imbalances between member countries of the Community;
- formerly external transactions between member countries will be "internalised" and national balances of payments will disappear and be replaced by a single balance of payments for the Community as a whole;
- monetary relations with non-Community countries will be determined at the Community level;
- interest rates on closely substitutable assets will be virtually identical throughout the Community and there will be no major differences in prices of tradable goods and rates of inflation between member countries.

and prevent exchange rate movements to be a source of macro economic disturbance and competitive distortion.

These changes have major consequences for both the functioning of the economy and the conduct of economic policy in the Community.

2. Implications: changes in competitiveness

The fundamental difference between a monetary union and the monetary arrangements presently in force in the Community is that, with the irrevocable locking of exchange rates and the elimination of fluctuations margins, all national currencies will be perfect substitutes, constituting in essence only different denominations of the same Community currency. With national balances of payments having disappeared, changes in some broadly defined measure of relative competitiveness[2] of member countries

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2. Such changes in competitiveness may result from different movements in wage costs and/or productivity; the different responsiveness of differently structured economies to external shocks (as, e.g., sharp variations of oil prices or prices of agricultural commodities); or permanent demand shifts prompted by changes in taste.

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will no longer show up in external disequilibria but manifest themselves in ~~shifts of demand away from less competitive to more competitive regions. In the absence of the possibility to alter exchange rate relations, the adjustment of these imbalances will be brought about by market mechanisms operating through changes in relative wages, movements of labour and, possibly, induced compensatory private capital flows. For instance, there would be a tendency for wages to decline in, and labour to emigrate from, those regions where relative competitiveness has declined. The extent and the speed of the market-induced adjustment process is, however, difficult to assess. Given the downward rigidity of wages and the continued existence of non-economic barriers to labour mobility, adjustment might not take place smoothly and could leave intolerable disparities in the level of output and employment between different regions of the Community. In order to avoid major dislocations and to mitigate adjustment burdens, a system of compensatory financing involving movements of funds from more competitive to less competitive regions might therefore be needed. Flows of investment capital and private transfers could be expected to produce some of the necessary offsetting movements of funds. However, to the extent that private flows did not suffice to reduce significantly income disparities they might - possibly for a fairly long period of time - have to be supplemented by financial transfer payments through official channels, i.e. through national budgets and the Community budget.~~

replace with A

3. Implications: fiscal and budgetary policies

A second set of consequences concerns the relationship between the stance of monetary and exchange rate policy on the one hand and fiscal and budgetary policies on the other. Three major issues arise:

Firstly, and perhaps most importantly, there is the problem of how to pursue an appropriate mix of monetary and fiscal policies for the Community as a whole. Given that monetary union implies one monetary policy (and a common exchange rate policy vis-à-vis the rest of the world) a macro-economic management of the monetary/fiscal policy mix would seem possible only if coherent and consistent fiscal policies are carried out at national levels - at least as long as the size of the Community budget remains small in comparison with national budgets. A particular mix of monetary and fiscal policy is not only required for the purpose of internal demand management in the Community, but it will also play an important role in the Community's relations with the rest of the world. For example, the

Note: This possibility does not exist today either. It should be said, perhaps.

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lack of an appropriate fiscal/monetary policy mix might expose the Community to the same kind of criticism that had been voiced about the US stance of macro-economic policy in recent years. Moreover, without the ability to formulate and execute a fiscal/monetary policy mix the Community could not participate in international efforts of policy co-ordination.

A second issue relates to the interaction between fiscal policy and the common monetary and exchange rate policy. Apart from the fact that interest rate effects produced by national fiscal policies might render monetary policy more difficult, the form in which budget deficits are financed might have direct repercussions on the common monetary and exchange rate policy. This would be, for instance, the case if national authorities had access to central bank credit. P But even if recourse to central bank credit is not possible, large-scale foreign borrowing by national public sector authorities (i.e. government borrowing in non-Community currencies) could affect directly the Community's exchange rate (if the proceeds from foreign borrowing were converted in the market) or the stance of monetary policy (if the proceeds were converted by monetary authorities).

P, an issue to be discussed à propos of the characteristics of the monetary autority of the Union.

Finally, there is a question about the degree of fiscal discipline that market mechanisms can be expected to exercise in the framework of a monetary union. At present strongly divergent national ~~[illegible] therefore constrain national fiscal policies. With exchange rates irrevocably fixed, the market's assessment of an excessively expansionary (or restrictive) fiscal policy would be expressed only in the form of different risk premia (i.e. divergent interest rates on similar types of governments securities), reflecting the markets' changing perceptions of the borrower's creditworthiness. Experience suggests that this market signal does not function smoothly. Rather than differentiating gradually between the quality of different borrowers, the markets' assessment tends to alter abruptly and major disruptions may occur in financial markets as borrowers find themselves suddenly shut off from access to private credit markets.~~

~~These potentially far-reaching consequences of a monetary union in combination with an unrestricted internal market point to the need of a number of functional and institutional arrangements in non-monetary areas [illegible]~~

replace with B

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1. <u>Functional arrangements</u>

(a) budgetary and fiscal policies

National fiscal policies [illegible] have to be co-ordinated [illegible] with a view to both avoiding financial and real disturbances from divergent policies and formulating a coherent monetary/fiscal policy mix for the Community as a whole [illegible] budgetary policies, both at national levels and the Community level, [illegible] have to embody a mechanism of transfer payments, aimed at alleviating economic imbalances between member countries which are not offset smoothly by market mechanisms.

(b) other policy areas

(<u>Dixon/Mingasson</u>)

2. <u>Institutional arrangements</u>

As monetary union implies the pursuit of <u>one</u> monetary policy, it follows that decisions on the stance of policy will have to be made collectively and that therefore institutional and legal changes **establishing a centre of monetary policy formulation will be required.** Such changes imply the loss of national autonomy over monetary policy. Responsibilities for the day-to-day execution of monetary policies will, however, not necessarily have to be centralised.

(a) budgetary and fiscal policies

In the non-monetary area institutional arrangements are more complex. [illegible] to the requirement of a joint fiscal policy [illegible] it might suffice to decide collectively on the size and the financing of the aggregate budgetary position of the Community. However, since that aggregate is equal to the sum of national budgetary positions (plus the balance on the relatively small Community budget), the collective decision on the overall stance of fiscal policy impinges indirectly on national budgetary decisions. In this sense, the need of a joint fiscal policy circumscribes national budgetary autonomy, but some degree of flexibility might exist in practice since an agreed aggregate target would be compatible with various combinations of national budtetary positions. Moreover, within the framework of an overall fiscal policy objective the national authorities would be largely free to chose the composition of expenditures and revenues. The curtailment of

? How closely would

? Should

As

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national autonomy would, however, be stricter if distortive micro-economic effects of government spending (e.g. in the form of subsidies) and, more importantly, of different methods to raise revenues were to be avoided. Roles governing subsidy payments and methods of taxation would have to be harmonised and decisions in these areas could no longer be made independently at the national level.

In order to achieve an adequate degree of fiscal policy co-ordination, the experience with the 1974 convergence decision (which in fact already lays down many of the necessary procedural steps) suggests that an entirely voluntary co-operation would not produce the desired results. In part that may be inherent in the process of budgetary decision-making where the ultimate budgetary responsibilities rest with national parliaments. A further reason is that in the budgetary field it is not possible to devise a simple economic constraint (as the exchange rate in the field of monetary policy) which could help to promote convergence of budgetary policies. In the absence of such a constraint it would seem inevitable that a common fiscal policy could only be put into effect on the basis of a system of binding rules and procedures. To this end all member countries would have to undertake - in the form of a treaty - to subordinate their national budgetary decision to a collectively formulated objective of fiscal policy and to accept clearly-defined and commonly agreed limitations on national budgetary positions. Undoubtedly, this will involve an extremely difficult decision-making process which can only be expected to function if the centre of decision were given rather far-reaching authorities.

(b) other policy areas

Additional institutional arrangements would also be needed in other non-monetary areas. (Dixon/Hingasson)

~~In conclusion, monetary union [illegible] transactions and removes exchange rate uncertainties, and therefore represents an important prerequisite for reaping the full benefit of an enlarged market in which goods, services and factors of production can move freely. At the same time monetary union would make it necessary to compensate for the loss of freedom from giving up exchange rate changes as an instrument of adjustment by arrangements ensuring a close co-ordination of various non-monetary~~

replace with C

~~policies. In this sense, complementary measures in the field of fiscal and budgetary policies, [illegible] policies and a range of microeconomic policies would seem to [illegible] indispensable elements of an economic [illegible]. Without such measures there would be a serious danger that major adjustment problems [illegible]~~

II. <u>The actual and prospective state of economic and monetary integration</u>

This section attempts to sum up the main features of economic and monetary union that were in place on the eve of the Single European Act or are expected to be implemented by the end of 1992.

1. <u>The situation on the eve of the Single European Act</u>

At that time only a few of the elements of an economic and monetary union were in place:

<u>Monetary integration</u> had proceeded in the sense that greater internal and external monetary stability had been achieved. The Community was nonetheless still far away from monetary union. The situation was characterised by the existence of:

- fixed but adjustable exchange rates linking the currencies of the members of the exchange rate mechanism; other member countries continued to manage the floating of their currencies;
- capital movements were restricted in a number of member countries and financial markets were segmented impeding seriously trade in financial services;
- while exchange rate constraints enforced a certain co-ordination of monetary policies, the Community did not have a common monetary policy with regard to internal and external objectives.

<u>Integration in the economic (non-monetary) field</u>, too, had progressed considerably after the elimination of tariffs and quotas on intra-Community trade in ? and some headway had been made in other policy areas (?). However, while in principle a free trade zone had been established, in practice the existence (and in some instances, the intensification of) frontier tariffs, subsidies, quotas on production, government procurement policy, technical standards, regulation of transport

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represented significant obstacles to the free flow of goods and non-financial services inside the Community. Despite the 1974 Council decision on economic convergence, no effective co-ordination of non-monetary policies took place. Structural policies were modest and lacked coherence (7).

2. The prospective situation at end-1992

On the assumption that the internal market programme will be implemented as scheduled, the state of integration at end-1992 will be characterised as follows:

In the monetary field:

- full capital mobility will have been established;
- banking and other financial markets will have been fully integrated;
- while further steps to enhance the process of co-ordination of monetary policies and changes in the operations of the EMS are not precluded, no decision to establish a single currency area has been taken.

In the economic (non-monetary) field:

- elimination of all restrictions on the movement of goods and non-financial services will have resulted in a genuine internal market, in which the allocative market mechanism will play freely;
- some modest progress will have been made on the macro-economic side as the size of the Community budget increases; however, it will still remain small in comparison with national budgets; no change in fiscal policy co-ordination is envisioned;
- the redistributive mechanisms will have been strengthened through the increase in the volume and the streamlined administration of regional and structural funds (7);
- some qualitative standards governing broad areas of social policy will have been put in place (7).

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III. <u>Conclusion and issues for discussion</u>

The note points to two major implications of a monetary union. On the one hand, a single currency area will enhance the efficiency of the Community's common internal market by lowering transaction costs and eliminating the risk of changes in exchange rates between Community currencies. On the other hand, the abandonment of the exchange rate as an adjustment instrument for intra-Community imbalances is likely to require a much greater degree of policy co-ordination in non-monetary areas, as well as arrangements to organise compensatory financing flows through official channels. The necessary co-ordination of policies, especially in the budgetary and fiscal field, does not seem attainable without institutional changes which, inevitably, would imply a curtailment of national autonomy in exchange for collective decision-making at the Community level.

If this broad assessment is shared by the Committee, there would be several basic issues for discussion:

1. <u>The principal features of a monetary union</u>

   - Which operational and institutional arrangements should characterise the monetary union as defined in the 1971 Council resolution? In particular, should there be a single currency or should the currency area comprise the existing national currencies?

   - Which degree of decentralisation of decision-making on and execution of a unified monetary policy would be compatible with monetary union as defined in the 1971 Council resolution?

   - What should be the principal organisational features of a central monetary institution?

   - What concrete proposals should the Committee make?

2. <u>The scope for and the organisation of policy co-ordination in non-monetary areas</u>

(a) budgetary and fiscal policies

~~[illegible] the formulation of a joint [illegible] policy be based? [illegible] would the overall objective be def[illegible] and how [illegible] translated into measurable targets?~~

replace with D

How should the pursuit of an overall fiscal objective be shared between individual national governments and between national budgets and the Community budget? How would consistancy between national budgetary policies and the overall fiscal objective be assured?

To what extent would the decision-making with regard to fiscal policy have to be centralised and what would the implications for the conduct of national budgetary policies be? How is policy co-ordination to be achieved and how would a necessary measure of flexibility, allowing quick responses to changing circumstances, be maintained? In this context, what lessons can be drawn from the 1974 convergence decision for the organisation of the co-ordination process?

What role should budgetary policies - both at the national levels and at the Community level - play in organising compensatory financial flows designed to alleviate the impact of economic imbalances between member countries?

What concrete proposals should the Committee make?

(b) other policy areas

(Dixon/Mingasson)