PART III

CONCRETE STEPS TOWARDS THE ECONOMIC AND MONETARY UNION

This first section should be presented as a proposed draft and not as an annotated outline seeking guidance from the Committee

Issues of method

In designing a step-by-step approach to economic and monetary union a number of methodological issues have been taken into consideration, which are dealt with below. These issues are relevant in establishing both the rationale and the implementation of a step-by-step approach and the Committee may want to consider whether their treatment should be part of the Report itself.

Gradualism and indivisibility: an economic and monetary union as outlined in Part I is too profound a change in the economic and institutional structure of the Community to be realized in one stroke. Economic behaviour ~~of~~ households, corporations, ~~unions,~~ and public administrations need time to adapt to a new setting. Similarly, the attribution of new competences to the Community cannot be made at once in all fields. It is necessary to build on success and to retain the possibility ~~to~~ for correct ing the course of action on the basis of experience. While these considerations point to the need for gradualism, it has to be recognised that policy decisions and operational responsibilities are, in may specific areas, not divisible. ~~Unless it is clearly indicated~~ who (i.e. whether ~~the~~ national Governments or the Community ~~level~~; ~~what~~ which organ or institution) has "the last word", policy conflicts will inevitably arise. As a consequence, the effectiveness in pursuing common goals will be undermined and the benefits sought through the

i.e. they cannot be transferred "piece by piece" but require a quantum jump.

economic and monetary union will be lost. It will be necessary to identify meaningful "blocs" of economic and policy competences and to link one to the other in such a way as to satisfy the need for gradualism while not trying to split what is indivisible.

Can this be spelled out in greater detail in order to make it clearer?

<u>Parallelism and disequilibria</u>: parallel advancement in many interrelated areas is a condition to avoid imbalances that could cause economic disruptions and loss of political support for the continuing process of developing the Community up to an economic and monetary union. Perfect parallelism, however, at each and every point of time is impossible and could even be counterproductive. Examples of this combination of partial parallelism in the development of the Community are: the shift of certain competences and not others (e.g. VAT as the common scheme for indirect taxation, with rates setting left to national governments), or progress in certain areas (e.g. the custom union) faster than in others (like the harmonization of legislation), etc. Advancement in one area may trigger advancement in others. The EMS has contributed to a greater economic convergence that has favoured capital market liberalization and the programme for completing the internal market. A certain amount of temporary ~~disequilibrium~~ deviation from parallelism may be part of the dynamic process of the Community. Parallelism has to be maintained in the medium term.

? parallel and divergent advancement ?

<u>Multiple speeds</u>: there is one Community, but not all the members participate fully in all its aspects at every point of time. So far this has mainly be the consequence of ~~successive~~ the decision enlargements and, for the EMS, of some countries not to join ~~joining~~ the exchange rate agreement in 1979. A common adesion to the final objectives of the Community and a unitary participation to the same "rule of law" and to the same set of institutions should be preserved, while allowing for a degree of flexibility in the timing in which certain arrangements will

Could or should this point be brought into connection with 4?

be entered by some member states. For each set arrangements the management of it should be the responsibility of those who fully participate in it.

should these principles be swapped with the preceding considerations into a single section introducing part II ?

1. Principles

The Report could explicity formulate a small number of principles (or choices) that have been retained in designing a process by steps. Such principles could for example be the following:

(i) one Treaty, several steps. The process by steps would be consistent with the objective designed in the Treaty and follow the rules established therein. The continuing adherence to the objective would be preserved throughout the implementation of the process.

(ii) containers and contents: the organs of the economic and monetary union would be established at the beginning, with all the institutional safeguards and organizational features that are deemed necessary. Through various steps additional competences would be attributed to such institutions. The container would be created at the outset, the content would be poured in gradually;

(iii) two institutions: the creation of a monetary union requires the establishment of a new Monetary institution that would have to be given a proper place in the existing constellation of Community institutions (European Council, Council of Ministers, European Parliament, Commission, Court of Justice); the Economic institution that is necessary to run the economic union, instead, may only be the result of suitable changes in the functions and responsibilities of institutions that already exist. While a degree of parallelism and interdependence between monetary and economic developments towards the union is

this is not really a principle of the same kind as the ones above

but if monetary policy is indivisible?

required, the two institutions should remain separate, to ensure from the outset that the conduct of monetary policy will seek the stability of the value of the currency as its primary objective.

While monetary + ec. policies form part of a comprehensive policy directed towards broad macro-economic objectives, they address specific issues and require a separate decision-making (one objective needs one instrument)

2. The ~~content~~ main strands of action

This whole section should be presented more in a form supposed to be part of the final report

The content of an economic and monetary union as described in the first Part of the Report is manifold. In certain areas the conditions required for an economic and monetary union are the results of a large number of actions to be developed by the Community in the legislative and executive sphere. In other areas such conditions can only be created through quantum jumps, to be made at the appropriate time. The two broad components of the union, economic and monetary matters respectively, can be furher subdivided in a limited number of areas for each of which the Report could review the main developments leading to the union. Such developments could be sketched as follows:

2.1 Moving to the Economic union.

The Committee has identified three sets of arrangements that are necessary for an economic union to meet minimal requirements:

i) arrangements ensuring effective freedom of movement for goods, persons, services and capital. To this end the Community needs: appropriate legislation to dismantle all technical and regulatory impediments; minimum harmonization of standards and tax treatment; adequate executive and judiciary authority to identify and sanction infringements of the Community law. The procedures and institutions that are necessary to reach this objective are already in place on the basis of the Treaty of Rome and the Single Act. The programme to complete the internal market by 1992 essentially covers this part of the economic union. To reach the 1992 objective on schedule, however, the Community has to accomplish a heavy legislative task, which covers controversial areas such as the harmonization of indirect taxation. Moreover, to overcome a potentially serious problem of non-compliance with the growing body of Community legislation that supports the integrated internal market, it is necessary to increase the effectiveness of the process whereby the Community law is enforced;

ii) arrangements to foster economic adjustment in conditions in which the ~~possibility of~~ need for exchange rate changes will disappear at some stage. Since adjustment should occur, to the maximun possible extent, by way of market mechanisms, such mechanisms should be made more effective. In the business sector this may require a stronger competition policy. In the labour market this would require promoting flexibility of wages and differentiated trends in labour costs according to the differences in productivity of the various regions of the Community. However, since even improved market mechanisms will not be sufficient to bring about adjustment, active policies will be necessary to supplement them. Such policies require financial resources, but have also an important qualitative dimension that may, if properly designed, significantly enhance the effectiveness of any given amount of funds made available through the Community budget. The program of doubling the resources of structural funds to 13 billion ECUs per year by 1992, coupled with the reorganization of Community structural policies, significantly improves the capacity of the Community to deal with this range of problems. However, the Committee may feel that in a more advanced stage of the process leading to the union such mechanisms should

This should be split up:

- arrangements to promote a better functioning of the markets' capability to accommodate disequilibria
- the transfer problem

be extended and made more effective. The Committee may wish to indicate, in this section of the Report, how this should be done, in both quantitative and qualitative terms. ... (this section could be completed with material drawn from a document that is in preparation)...

iii) constraints on national budgetary policies. In this area, progress towards the economic and monetary union should follow two directions. In the first place, it should strengthen the safeguards against fiscal imbalances that may jeopardize monetary stability in the union. Such safeguards should include at least limits to the external (i.e. in foreign currencies) borrowing and to the direct or indirect monetary financing of national deficits. At a certain stage they should also consider the introduction of binding rules limiting the size of (current) fiscal deficits relative to GDP, on a cyclically adjusted basis. In the second place constraints on national budgets are necessary to put the Community in the position to conduct its own fiscal-monetary mix before the Community budget reaches a size sufficient to exert a significant macro-economic influence. For both these reasons the decision on economic convergence of 1974 will have to be reviewed and made more effective.

On points ii) and iii):

Should the Report put forward the idea of a "European Fiscal System"? Such proposal would outline the principles of a comprehensive set of fiscal arrangements concerning both national and Community budgets and covering such matters as deficits, deficit financing, tax harmonization, respective roles of national and Community budgets, "own resources" of the Community budget, etc..

2.2 Moving to the monetary union

The monetary union will be the result of progress accomplished on the various components of the definition explained in Part I of the Report: convertibility of currencies, irrevocable locking of parities, liberalization of capital transactions, integration of banking and financial markets, ~~uniqueness of~~ one monetary policy. For each of these fields, the Report could outline the evolution leading to a monetary union along the following lines:

+ micro-economic requirements

→ move from national currencies to one single currency?

i) irrevocable locking of parities. In dealing with the final stage of the monetary union, Part I will have described the operational features of a system based on parities irrevocably fixed by construction. Here the Report will have to indicate what intermediate steps are possible and advisable to move to such final system from the "fixed but adjustable" regime of the EMS. The single currency vs. national currencies issue will have been discussed in Part I and will be taken up again here. So will the role of the ECU. The intermediate steps towards the irrevocable locking of parities involve two kinds of arrangements. Firstly, a reformulation of the exchange rate agreement, that could consist, for example, in narrowing the existing 2.25 margins and perhaps in a modification of the procedures for realignments. It may be noted that greater fixity in exchange rates should perhaps result more from reducing the frequency and size of realignments than from narrowing the permitted margins of fluctuation. However, to devise a "rule" that would make realignments less frequent and smaller in size is difficult. The Committee may wish to take a position on this point. Secondly, and more importantly, steps should lead to a common "domestic" monetary policy, i.e. to a single decision-making process whereby the money supply of the Community is managed in common as a total, with the aim of providing price stability throughout the union. The difficult problem, here, is that the movement from many national monetary policies to one common policy

role of ECU not a feature of the final objective, except that the single currency could be called "ECU" (but would be something different from the present ECU)

→ should there be a separate section on the ECU?

→ would it be enough to be more general here? but more specific about the implementation of this idea in the description of stages?

may not be really divisible in steps. A stepwise approach may even entail the risk of losing a national anchor before a Community anchor is firmly established. The Committee will discuss what should be said in this crucial part of the Report. If the view were that this change can only be made in one step, the problems would be: firstly, preparing this step, for instance by improving and deepening the process of ex ante consultation, and, secondly, deciding when to take this step.

it would perhaps be helpful to spell this out in greater detail

ii) irreversible convertibility of currencies and legislation concerning the currency. Convertibility of currency is now fully established in Community countries. The Committee, however, may want to consider whether this should be more firmly established in the Community law. In a related field, it may consider whether legislation concerning currency arrangements (e.g. clauses of indexation legislation concerning the ECU status of legal tender, etc.) should be proposed;

? necessary? possible?

in the ECU paragraph?

iii) liberalization of capital transactions: The coming into force, on July 1st 1990, of the directive on the liberalization of short-term capital movements would complete the process of liberalization of capital transactions. However, the problem of achieving the minimum harmonization in the tax treatment of capital revenues is still unresolved. The Commission will present proposals before the end of 1988. In its report the Committee may want both to stress the importance of such harmonization and express its views about the proposals put forward by the Commission;

yes!

?

iv) full integration of banking and financial markets. This should be achieved by the end of 1992, as part of the program of completing the internal market. The necessary directives are in the process of being prepared by the

Commission or have already been presented and are now in discussion before the Council. Complex technical issues remain to be solved, as well as the problems of reconciling different financial structures and traditions. The monetary union will require, in addition to what is being prepared, a function of prudential supervision exerted at the Community level, at least in the banking field, which is closest to monetary policy. The Monetary institution to be created in order to operate the monetary union would have to exert such functions, while preserving the maximum degree of decentralization compatible with the union.

This description of evolutionary lines for the various areas of a monetary union doesn't do full justice to the strong interconnections between the areas, nor to the need for "horizontal" consistency between the situations reached on each of these several fronts. The most important of such interconnections concerns the three areas of banking services, mobility of short-term capital and monetary policy (including exchange rate management). In a situation in which every bank of the Community is free to offer deposits and loans in every currency, to every households or firm of every country, and in which - correspondingly - every households or firm is free to hold deposits with any bank and in any currency of the Community, the conduct of monetary policy at the national level will become extremely difficult if not impossible, because national monetary authorities will have lost their traditional basis, which is the large degree of territorial coincidence between their area of jurisdiction, the area in which their currency is used, and the area in which the banking system is operating. The "steps" will have to be devised taking carefully into account these interdependencies.

Would it be useful to incorporate these considerations into (c) on p7, in the part dealing with a common monetary policy?

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

... (should there be a sub-section on this subject?) — yes!

...

3. <u>Three steps</u>

The request made by the European Council to the Committee to study "concrete steps" reflects the fact that the process will have to be divided into a limited number of clearly defined stages. Each stage should represent a significant change with respect to the preceding one. It is expected that the new arrangements coming into force at the beginning of each stage would develop their effects over time, bringing about a change in economic reality such that the time for the next stage becomes gradually ripe.

— start with reference to introductory problem of this part which sets out the principles

[~~At the~~ time this outline is drafted the Committee has devoted some time ~~to the~~ discussion of the final stage (described in Part I above) and to the ~~content~~ and organization of a possible first step. What follows ~~is an~~] hypothesis of moving to the economic and monetary union in three steps, i.e. with a step that comes in between the two which the Committee has already discussed. Such an hypothesis is presented with the intention to stimulate further discussion in the Committee. The Committee might want to examine the content of each step by keeping in mind the considerations developed above about "gradualism, indivisibility and parallelism". This may be necessary in order to ascertain the viability of the proposed "splitting" of certain functions in the conduct of monetary policy or exchange market intervention policy. Similarly, the inclusion of a particular item into a particular step may be subject to reconsideration (e.g. the narrowing of margins could be part of step 1 or of

The Committee [agrees] that the process of [illegible] could be subdivided into [2] [3] steps

→ Should the ideas behind the proposed skeleton be explained in a clear note?

step 2).

The content of the three steps could be the following:

to whom would these steps apply? to all or only those agreeing to them? What are the implications for

a) Step one:

In the economic field:

- completion (or significant advancement, if "step one" were to be proposed for 1990) of the internal market as planned in the Single Act;
- full implementation of (or significant advancement in) the "Brussels package" of doubling the structural funds and ....(to be completed)....;

  Is this for 1990?

- replacement of the 1974 Council Decision on economic convergence by a new procedure for fiscal policy coordination. This would be based on quantitative guidelines, expressed as a percent of GDP ~~aimed at~~ (such as ....) singling out inadequate fiscal performances and triggering a procedure of consultations and monitoring of the same kind as that applying to conditional Community credits.

  Should we elaborate:
  - should a member have to explain and publicly non-compliance with guidelines?
  - could this be challenged by others?
  - any procedures to bring those back in line who are outside of proposed guidelines?

In the monetary field:

- creation of the monetary institution with all its legal underpinnings (objective of monetary stability, autonomy, independence, accountability, decision-making procedures) according to Part I of the Report. The institution would ~~inherit~~ incorporate all the present EMS and monetary arrangements (EMCF, Committee of Governors, competence over the ECU, etc.),
- the institution should have its own balance sheet, separated from those of member central banks, in order to carry out discretional interventions.

  Should this start perhaps with definition of tasks, then prerequisites in terms of institutional and operational minimum arrangements?

  On the asset side it would have:

  1) a certain amount of reserves, which would be definitively pooled allowing the conduct of interventions

in external currencies (dollar, yen);

2) credits to member central banks deriving from the power to grant them discretionary loans <u>or to call reserves from them</u> (symmetric "credit" mechanism); this would substitute all existing (predominantly automatic) credit mechanisms, except for the pure very-short-term financing; this latter mechanism would remain in operation, albeit with shorter duration in order to induce central banks to have recourse to credit by the monetary institution.

If a monetary institution → should it have long-term loans to national central banks? Loans to governments excluded? What would happen to the existing medium-term financing mechanisms?

On the <u>liability side</u> the monetary institution would have ECUs to be held (only?) by member central banks;

anything about settlement procedures? Through the accounts of the new institution?

- the institution would be responsible for determining the cost of the credit extended to member central banks;
- the monetary institution should be mandatorily consulted <u>ex ante</u> about domestic monetary policies; the outcome of this consultation together with a periodic assessment of member central bank monetary policy behaviour should be made public;
- <u>ex ante</u> consultation in the matters of common interest concerning banking supervision;
- narrowing of margins of fluctuations from 2.25 to 1 (?) per cent;
- reinforcement of the committement to decide parity changes through a common procedure;
- constitution of a small staff to support and influence the operational decisions of the monetary institution, to prepare the consultations and the public declarations.

<u>b</u>) <u>Step two</u>:

In the <u>economic</u> field:
- creation of the Economic institution;

- introduction of binding restrictions to the external borrowing and monetary financing to cover domestic budgetary deficits; → part of step 1 ?
- creation of a European fiscal system as outlined in section 2 above: improved procedures, actions and resources for structural policies; a linkage between own resources of the Community budget and the budgetary situation of member states; etc.

In the monetary field:
- all the external monetary relations will become the sole responsibility of the Monetary institution: external interventions, participation in the monetary meetings of the G3, etc.;
- national monetary objectives will have to be agreed within the Monetary institution, and monitored by it;
- the Monetary institution will have the capacity to conduct intra-EMS interventions;
- anything about realignments?

c) Step three (final stage; this will have to be consistent with what is said in Part I. It should be observed that the so called "final stage" is not necessarily a stage beyond which the system will not be susceptible of further evolution. Rather, it is one in which the fundamental requirements of the definition of an economic and monetary union have been fulfilled albeit in a setting that may be subject to changes and improvements.):

In the economic field:
- the ~~Monetary~~ Economic institution will have the authority to impose constraints on national budgets when this is required to prevent imbalances that may threaten monetary stability, or when it is required for the achievement of the desirable policy mix of the

Community as a whole;

- the European fiscal system will come fully into force.

In the monetary field:

- parities will be irrevocably locked and the Monetary institution will start operating will full competence for the monetary policy decisions of the Community, as described in Part I.

micro-economic requirements?
Switch to one currency?

4. Procedures

This final section of Part III would contain specific proposals about the procedures of setting in motion the whole process and moving from one stage to the next. The following are preliminary ideas on some of the items that will find a place in this section (the Committee may want to add more).

Should this section perhaps precede the description of steps?
or possibly be also included in the introductory section on principles + methods?

Legal basis. A treaty will be stipulated on the basis of Article 236 of the Treaty of Rome, such that it would provide a legal basis for all the actions and developments that are required to reach the economic and monetary union. Given the gradualistic approach, many of the clauses of the Treaty will come into force only at a later stage. The "Treaty from the outset" approach has always been followed by the Community in its developments, and appears to be the only way to establish the process on firm ground and to give it the necessary credibility.

Timing. No dates were attached to the hypothesis of three steps described above. While it seems not possible to set a deadline for the final stage, for the first step a date appears to be necessary. Decisions that have already been taken or planned with a precise calendar constitute a natural reference for setting the pace of the first (two) step(s). The relevant dates are 1990, for the complete liberalization of capital movements, and January 1st 1993, for the coming into force of the internal market, including the market for banking and other financial services. In discussing the timing of the first step and the question of whether a date should be set for the second step, the Committee will take account of these two dates. It has also to be considered that each stage contains a program of legislative actions that the Community has to fulfill, as well as the need to test the arrangements established at the beginning of the stage.

<u>Moving from one stage to the next</u>. A procedure will have to be proposed in the Report on how to decide the passage from one stage to the next. Unanimity has been suggested by some members of the Committee. Is it to be adopted as the rule for all the stages? Who should participate in the decision? Another aspect of this decision-making process will concern the indication of the body, or bodies, that will take the decision. The European Council may have to take the final decision, but what say will have the organs of the Economic institution and Monetary institution respectively in proposing, or giving advice about, this decision?

~~<u>Location</u>. For the Monetary institution a decision will have to be taken about the location. The note prepared by Governor de Larosière suggests that the location could be Basle for the first stage. Should the decision about the final location be taken at the outset? Where would the monetary institution be located?~~

TPS
7.11.88