COMMITTEE FOR THE STUDY OF ECONOMIC AND MONETARY UNION

CSEMU/4/88
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Monetary union and a European system of central banks

1. October meeting

At its second meeting (Luxembourg, October 1988) the Committee discussed the essential features of an economic union consistent with a monetary union. These fall into three broad categories. Firstly, arrangements ensuring effective freedom of movement for goods, persons, services and capital. Secondly, arrangements to foster economic adjustment without exchange rate changes, which are, by definition, ruled out in a monetary union. Such arrangements range from the removal of impediments to the working of market mechanisms (e.g. competition policy) to adjustment-promoting regional policies in combination with financial transfers (e.g. training programmes). Thirdly, constraints on national budgetary policies to prevent fiscal imbalances which might jeopardise monetary stability in the union. These additional constraints on national budgetary policies, ranging from strengthened fiscal co-ordination to binding rules of budgetary discipline, were regarded as necessary as it was generally felt that market discipline would be too weak and work too slowly.

There was a general view that the process of realising economic and monetary union would require, from the outset, the drafting of a new treaty. This treaty should define the final stage, and indicate clearly how the constituent parts of the union would be assembled. It should also specify the procedures for moving from one stage to the next, with each stage being consistent with the final objective.

2. Monetary union

At the October meeting the existence of a monetary union was taken as given. A discussion of its structure and features is planned for November.

In its debates so far the Committee has retained the definition of monetary union presented in the Werner Report and in the 1971 Resolution:

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

The implementation of (b) has already been agreed upon: complete liberalisation of capital transactions is scheduled for July 1990, full integration of banking and other financial services for January 1993. As to (a), there is broad agreement that greater co-ordination of monetary policies would not be sufficient to create a "single currency area" through the "irrevocable locking of parities". What is required is one monetary policy and an organ capable of taking operational decisions on a continuous basis.

The problems that have to be solved in order to establish a monetary union as defined above are essentially related to two sets of issues: one concerns the institution in question, its organisation and tasks; the other concerns the currency and related arrangements. Without disregarding the strong interrelations between them, these issues may be discussed separately. Problems concerning the institution could be discussed in November on the basis of the notes submitted by Governor Godeaux, Governor de Larosière and Professor Thygesen. The following meeting could concentrate on the currency issues, with the help of notes prepared by Governor Ciampi and President Duisenberg, on the parallel currency concept and the ECU respectively.

3. Issues for the November meeting

At the meeting in November the Committee may wish to examine the following institutional issues:

(a) Principles

As a starting point the Committee may refer to what President Pöhl has called the "decisive principles that absolutely must be taken into account when setting up a European central bank system" (p. 12-14 of the paper "Further Development of the European Monetary System"):

(i) mandate to maintain stability of the value of money as the prime objective of European monetary policy;
(ii) independence from national governments and Community authorities;
(iii) voting power based on the economic importance of the member countries;
(iv) a federal structure;
(v) limitations on credit that can be granted to public authorities, including those of the Community;
(vi) policy instruments capable of managing the money supply effectively without recourse to quantitative controls;
(vii) banking supervision integrated with the independent European central bank.

An additional issue of principle, which is touched upon in President Pöhl's paper and which the Committee may wish to discuss, is the accountability of a European central bank.

(b) A system of European central banks ("the Centre")

In designing the organs of a monetary union it is natural to draw inspiration from decentralised central banks and monetary organisations in nations with a federal structure. The Deutsche Bundesbank and the US Federal Reserve System are useful examples to be referred to in this respect.

Four questions seem particularly relevant in the design of a European system of central banks. Firstly, it will have to be decided which monetary policy decisions will have to be taken by the Centre and which may be left to local (national) central banks. Secondly, to what extent does the Centre need operational instruments and to what extent may it rely on the "executive arm" of one or more of the national central banks (as in the case of the Board of the Fed in Washington and the Federal Reserve Bank of New York)? Thirdly, the problem of the internal structure of a system of European central banks, the governing bodies and decision-making procedures. Finally, the place of the new institution in the system of Community and national institutions, including questions relating to the appointment of members of the governing bodies, terms of office, and relationships with other Community institutions.

Some of these issues are expected to be addressed in the note prepared by Professor Thygesen.

(c) <u>The first step</u>

At the October meeting it was suggested that the first step on the way to monetary union should be based on a new treaty and that stage one should be an "embryo" of the final situation, in the sense that it should contain the essential ingredients of that situation. It was also suggested that the Centre should from the start be given "something to manage", i.e. a policy responsibility.

The note prepared by Governor de Larosière will provide the basis for a preliminary discussion of the first step.