1989 III 7 10:28

FAX COVER SHEET

HEAD OFFICE: THREADNEEDLE ST. LONDON EC2R 8AH. 01-601 4444. TELEX 885001. FAX: 01-601 4771

PLEASE DELIVER THIS PAGE, PLUS 16 FOLLOWING PAGES, TO

NAME : Dr Gunter Baer.

LOCATION :

PHONE & EXT :

SENDER : [redacted]

OFFICE :

PADS CODE : 410-P
(Bank Internal post code)

PHONE NO. : 601-4121 LOCAL FAX NO. : 601-4953

4724q

CONFIDENTIAL

III Concrete steps towards economic and monetary union

1 Principles governing a step by step approach

1 As is apparent from the previous two chapters of the Committee's report, there is a very considerable gap between what has so far been achieved, in terms of the substantial progress made in monetary policy co-ordination and promoting exchange rate stability, and what would need to be done to reach full EMU. In particular, as discussed in Chapter II, EMU would only be possible when a number of important and difficult prerequisites had been met: the underlying economic conditions would need to be conducive to the sustainability of the union, there would have to be the political will to see the necessary transfer of power from member states to the Community, and mechanisms would need to be in place to enable appropriate economic policies to be formulated and implemented both efficiently and effectively.

2 As far as ensuring that the underlying economic conditions were right, the key requirement would be that the markets for goods, services, capital and labour throughout the Community were sufficiently integrated and flexible to make it feasible to abandon the exchange rate as an adjustment mechanism. Completion of the internal market legislative programme is the present priority, but even after 1992 time will be needed to allow markets to adjust to the new legal framework and to enable the potential of that programme to be realised. A key longer term consideration is whether EMU would be politically acceptable to certain member states whilst significant differences in national income levels remained and, if it would not be acceptable, how those differences might best be reduced.

3 On the political front, EMU would involve a major shift in economic decision-making power from member states to the Community as a whole. Key areas of macroeconomic policy would have to be determined collectively or at least be subject to constraints that were determined collectively. This would necessitate both a

willingness to engage in binding ex-ante co-ordination and, eventually, the transfer of appropriate powers to relevant Community institutions. This would involve its own difficult problems such as, for example, determining the appropriate division of responsibilities between central banks and governments at the Community level.

4 Finally, the policies that the Community would need to set would include not only monetary policy but also exchange rate policy towards non-Community currencies and significant constraints on member states' fiscal policies (in particular, limits on budget imbalances and on how such imbalances are financed). Such policies are aimed at key economic variables, such as price stability, growth, income distribution and unemployment, which are inevitably politically sensitive. This is true at the moment within member states, and the task of reconciling conflicting views amongst the Community as a whole would inevitably be even more challenging.

5 The Committee therefore believes that economic and monetary union would be too profound a change in the economic and institutional structure of the Community to be realised at one stroke. Rather, the process would be a long one and a step by step approach would be necessary. Moreover, the failure of earlier attempts to achieve EMU suggests that it would be important always to build on success and to retain flexibility. It would be necessary to be able to respond to economic and monetary conditions in the Community as they develop and to be able to modify any course of action in the light of experience gained or in order to allow for the impact of developments external to the Community.

6 The Committee is of the view that, in addition to the general principle of subsidiarity explained earlier in this Report, a number of considerations have to be taken into account in designing a flexible step-by-step approach to EMU.

(a) Discrete but evolutionary stages

7 The approach outlined below illustrates how EMU might develop. It is based on three apparently discrete stages reflecting the points at which institutional change might be

involved or at which major policy decisions (such as the move to irrevocably fixed exchange rates) might be required. But the approach should be an evolutionary one and flexibility will be needed in determining the content of each stage. Because achieving EMU will be a long process, conditions will change inside and outside the Community, as will beliefs in the appropriateness of particular policies. There must be room for modification in the light of experience rather than pursuing a prescribed and detailed course of action.

(b) Parallelism

8 Parallelism - in the sense of moving at an equal pace towards EMU in the many areas where action is needed - is important in order to avoid imbalances which could cause economic strains and the loss of political support for the process. Perfect parallelism at all times is impossible. 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 front is a necessary condition for further progress on the monetary front. Otherwise too great a strain would be put on monetary policy.

(c) Calendar

9 In the same way that flexibility is needed in determining the content of each stage, the Committee considers that the timing of the moves from stage to stage cannot be set in advance but will have to be judged in the light of circumstances. This is an essential part of the evolutionary and flexible approach. However, it would be appropriate to give a clear indication of the timing of the start of the first stage, and the Committee suggests that this could be July 1990 when the directive for the full liberalisation of capital movements comes into force.

(d) Indivisibility and gradualism

10 The Committee believes that any new institutions would have to be carefully designed. On the one hand it can be argued that institutional change is necessary from the outset as a bold step

to demonstrate political commitment to early and real progress. On the other hand it can be argued that much needs to be done before new institutions could perform useful tasks and that the credibility of new institutions could be destroyed if they were established before member states were willing to transfer power to them. The Committee considered that to avoid the risk of policy conflict and market uncertainty it would in any event be important to ensure that responsibility for particular areas of policy was at all times well defined. It would need to be clear, for example, whether ultimate responsibility lay at the Community or at the national level and, in each case, with which institutions.

(e) Participation

11 The Committee considered the possibility that some member states might take institutional steps before others were prepared 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.

(f) Role of the ECU in the evolutionary approach

12 In considering how EMU would best be achieved, the Committee looked at the possible attractions of developing a parallel currency, the ECU, in such a way that it would gradually displace existing national currencies and eventually take over as a single currency for the Community. However, although this was a superficially attractive approach, the Committee decided that the arguments in its favour were not convincing. Besides being too difficult to achieve without unacceptable costs, the Committee felt that it would not contribute to solving in an orderly manner the problem of co-ordinating national monetary policies; on the contrary it would add a thirteenth currency to an already difficult co-ordination exercise and there was a risk that it might undermine monetary policies oriented towards price stability. The development of a parallel currency would also not avoid the need for institutional change or the difficult questions that such change would pose.

13 Nevertheless, the Committee recognised that at the start of the final stage of EMU some form of parallel currency arrangement would be needed to make the transition from irrevocably fixed exchange rates to a single currency feasible. Moreover, in view of their belief, expressed in Chapter II of this Report, that the ECU should in due course become the Community's single currency, the Committee felt that in the meantime it would be sensible to continue to promote the use of the ECU whilst recognising that for several years to come any increase in its use was likely to be gradual and should, in any case, be dictated largely by market demand.

A three stage process

14 The Committee, having examined a number of possible approaches, considered that, as a broad indication, concrete steps in any move towards EMU might be along the following lines.

Stage 1 [closer cooperation and coordination]

- completion of the internal market, including full liberalisation of capital movements;

- closer policy coordination, including increasing willingness to consult ex-ante;

- further enhancement, as necessary, of the effective working of the ERM; all Member States to bring their currencies within the narrow margins of the ERM;

- development of existing institutions to promote the greater degree of monetary and economic policy co-ordination.

Stage 2 [soft union]

- joint formulation of monetary policy and more formal centralisation of coordination of fiscal policy; outcome of coordination process increasingly binding;

- greater exchange rate stability within the ERM (and, possibly, narrower ERM margins) but central rates still adjustable if necessary; joint fomulation and co-ordinated execution of exchange rate policy in relation to third countries;

- new institution(s) established in embryo and given limited functions;

Stage 3 [hard union]

- fixed exchange rates, moving as soon as practicable to a single currency;

- single monetary policy; single exchange rate policy (in relation to third countries' currencies);

- acceptance of agreed constraints to fiscal policy as being binding;

- new institutions fully in place.

15 The Committee believes that a staged process would be sensible for the following reasons. The first priority would be to complete the internal market and demonstrate that, using the considerable powers that already exist, closer policy co-ordination and economic convergence and integration would be feasible. This would be the key task of Stage 1 - getting the fundamental economic conditions right and establishing in practice that the necessary political will existed. Once this had been achieved, attention could be focussed on limiting exchange rate movements and institutionalising the joint-decision making process (stage 2). A move to full EMU (stage 3) would only take place when experience with this softer form of union had been found to be satisfactory.

16 However, the Committee wishes to emphasise that the division into three stages, according to particular institutional requirements, is primarily expositional. As indicated above, the process will largely be evolutionary and the detailed form that

each stage should take could only be determined in the light of experience with the preceding stage. Because of this, the more detailed outline below of the three stages focusses on stage 1, and the discussion of stages 2 and 3 concentrates on the issues that would need to be decided when it was felt that the transition to these stages was feasible.

3 Stage 1

17 During this stage the emphasis would be on achieving the necessary political and economic conditions and on greater ex-ante coordination of policy.

18 In the economic field:

(a) complete removal of internal barriers and the liberalisation of movement of goods, services, labour and capital within the Community, according to the internal market programme; strengthening of Community competition policy;

(b) the full and cost effective implementation of the "Brussels package" for reforming and doubling the structural funds by 1993, designed to strengthen substantially the ability of Community policies to promote regional development and to correct economic imbalances;

(c) the replacement of the 1974 Council Decision on economic convergence by a new procedure for an increasing degree of economic and fiscal policy co-ordination. An important aim of the new procedure would be to encourage the reduction of fiscal deficits and to improve the assessment of the economic policies of the member states. The assessment would form the basis for a more effective co-ordination of macro-economic policies, with co-ordination being based on recommendations and carried out with due account of the views of the Committee of Governors. The new procedure would provide for the regular discussion in ECOFIN, on the basis of preparatory work by the Monetary Committee and Committee of Governors, and with the attendance when appropriate of Central Bank Governors, of:

- the co-ordination of fiscal and monetary policies;

- policy co-ordination on fiscal imbalances, with quantitative medium-term guidelines; and a programme for the reduction, where necessary, of budget deficits to specified levels;

- guidelines for the financing of national budget deficits, to reduce and eventually eliminate monetary financing;

- multilateral surveillance of economic performance and policies, based on macro-economic indicators. Where developments are judged inadequate or detrimental to commonly set objectives, these would trigger recommendations regarding the future course of national policies.

19 In the monetary field:

(a) the liberalisation of all capital movements in the Community, as provided for in the June 1988 directive;

(b) policy co-ordination: 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 authority and visibility and a permanent Secretariat with a research facility. The thrust of the revision to the 1964 Council Decision would be to encourage a strengthening of the co-ordination of monetary policy among all member countries of the Community. To this end, the Committee would:

- formulate recommendations 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 consider national decisions on the course of monetary policy, such as the setting of annual domestic monetary and credit targets;

- make policy recommendations to individual governments and to the Council of Ministers on non-monetary policies that could affect the internal and external monetary situation of the Community, especially the functioning of the EMS;

- submit an annual report on its activities and the monetary situation of the Community to the European Parliament;

- set up a sub-committee to start regular consultations concerning matters of common interest in the field of banking supervision.

The responsibilities and procedures of the Monetary Committee would be enhanced in parallel with the Committee of Central Bank Governors.

(c) EMS arrangements. The Committees would consider what further specific steps might be appropriate to strengthen exchange rate management within the Community. These might include:

- a general move, undertaken at appropriate moments, towards increased holdings of EC currencies in member states' reserves, and their use, where appropriate, in intervention.

- Countries that do not participate in the ERM might be permitted to participate, if they wished, in the Very Short-Term Financing facility (VSTF). They would agree to lend under the facility in return for the ability to draw on it.

- Market rate on government short-term ecu paper to be used as the rate of remuneration on official claims arising in the ERM.

- Before the end of stage 1, all member states to bring their currencies within the narrow margins of the ERM.

(d) ECU arrangements: removal of regulatory impediments that may prevent market participants using the ECU in setting prices, keeping accounts, and contracting and settling any kind of financial obligations. Greater use of the private ECU as a currency to be held in national reserves and for use in intervention (including acceptance of the private ECU in settlement of obligations arising from VSTF transactions in the EMS). Increased borrowing by member states in the form of debt obligations denominated and payable in ECU. The ECU would remain a basket currency.

4 Stage 2

20 The need for a flexible approach suggests that the detail of Stage 2 should not be settled until conditions were right for the transition from Stage 1 to Stage 2. However, it is possible to illustrate a range of options.

21 A key feature of this stage would be that the outcome of the ex-ante co-ordination process described in Stage 1 would become increasingly binding on member states. An important policy objective would be to achieve increased exchange rate stability in the narrow band of the ERM. Some degree of institutional change would probably be desirable in order to assist the co-ordination and implementation of policies.

22 In the economic field the progressively tighter co-ordination of policy formulation and its implementation could be in achieved various ways. Decisions would continue to be taken by finance ministers but it would appropriate to reconsider the form in which they should meet and the supporting facilities they might need. One possible approach might be simply to continue with the arrangements established in Stage 1. However as the need for closer co-ordination grew and the outcome of the process became increasingly binding, this might prove unmanageable. It might therefore be desirable to establish some form of permanent secretariat to provide ECOFIN with analysis and advice; this secretariat could be staffed by officials from national finance ministries. There might also be scope for easing the burden on ECOFIN by establishing a committee of junior ministers able to

prepare the groundwork. In this case it might be appropriate to rationalise the existing roles of Coreper, the Monetary Committee and the Economic Policy Committee with respect to ECOFIN.

23 A possible extension of this approach would be to institutionalise these arrangements by setting up a new body, perhaps a Centre for Economic Policy Co-ordination (CEPC), which would take over from ECOFIN responsibility for co-ordination of certain key aspects of macroeconomic and budgetary policy making. Finance ministers would still take the decisions in the CEPC but, by formally separating these elements of policy from other Community policy, the greatly increased importance of co-ordination in this sphere would be recognised and it would be easier to design special arrangements to ensure that this decision-making process worked smoothly.

24 In terms of policies, it is likely that during Stage 2 there would need to be:

- the introduction of progressively more precise rules relating to the size of budget deficits and their financing;

- the adoption of medium-term guidelines for key financial targets and economic programmes in the member states;

- the joint adoption of budgetary objectives when felt appropriate, as part of a co-ordinated budgetary and economic policy;

- the formulation of a common view on the exchange rates of Community currencies vis-a-vis major third currencies.

A decision would also need to be taken on the extent to which co-ordination was necessary in other areas of fiscal policy.

25 In the <u>monetary field</u> a key objective of Stage 2 in terms of co-ordinated monetary and exchange rate policies would be greater exchange rate stability within the ERM, perhaps leading to a narrowing of the fluctuation margins of the mechanism; however, central rates would still be adjustable if necessary. There would also be joint formulation and co-ordinated execution of exchange rate policy in relation to third countries.

26 The Committee felt it would be desirable in Stage 2 to set up, at least in embryo, the institution (the European System of Central Banks) which would be required in Stage 3 to help to determine and implement the common monetary and exchange rate policy.

27 [As discussed in Chapter II of this Report], there would be broadly two options. Firstly, decisions could be taken by the central monetary board of the ESCB but execution of policy left to national central banks - the so-called federal approach. Alternatively, the central board as well as determining policy could be responsible for implementing certain elements where this would not result in a loss of efficiency - the so-called centralist approach; one such element might be the implementation of exchange rate policy vis-a-vis non-Community currencies. The first of these options would be more in keeping with the principle of subsidiarity but the decision taken at this stage would need to take into account the final form envisaged for Stage 3.

28 As well as the degree to which implementation of policy was left to national central banks, a key decision would have to be taken during Stage 2 on the appropriate balance of responsibilities and competencies between the ESCB and the CEPC in respect of monetary and exchange rate policy.

Stage 3

29 Stage 3 would be the end of the process of achieving EMU and therefore its essential elements have already been discussed in Chapter II of this Report. The crucial difference between Stages 2 and 3 would be that exchange rates would be irrevocably fixed from the start of Stage 3. By the beginning of this stage the outcome of the co-ordination processes would also need to be fully binding in the relevant areas. It would have to be decided, in the light of experience with the previous two stages, whether further institutional changes might be needed to reflect both the transfer of power from national to Community level that would have taken place by Stage 3 and also the irreversibility of the final step.

30 In the economic field the question would again arise of whether the existing arrangements needed formalising or strengthening in any way. The options would remain essentially as in Stage 2.

31 In terms of policy, a decision would have to be taken whether to continue the development assistance, if any, provided during earlier stages to make the transition to EMU more manageable and acceptable to some member states. It would also have to be decided whether, exchange rates having been fixed, some sort of transfer mechanism would be needed to provide temporary adjustment assistance to regions adversely affected by exogenous shocks or whether market prices were sufficiently flexible to make such temporary relief unnecessary.

32 In the monetary field, the ESCB would assume responsibility for any aspects of monetary and exchange rate policy it had not already acquired. As in Stage 2, however, the ESCB could be developed either in federal form (with implementation of policy devolved upon national central banks as appropriate) or in a centralised form (with policy implemented by the decision making body, independently capitalised).

33 The key development during the course of Stage 3 would be the transition from fixed exchange rates to a single currency as soon as this became practicable. The primary consideration here would be the need to convince the markets that monetary union was irreversible, although another important consideration would be the potential gains in efficiency offered by the existence of a single currency unit rather than twelve.

6 Further considerations

34 The Committee believes that there are three further essential elements which need to be born in mind when considering progress towards EMU. These are outside the competence of members of the present Committee, but, because of their importance, they are outlined briefly below.

35 National parliamentary approval. The proposed transfer of powers in Stage 2 could not take place in most [all?] member states without domestic legislation or even constitutional amendment.

36 Treaty change. Institutional change of the kind required to achieve EMU would at some point necessarily entail amendments to Treaty of Rome. However, this would not be needed until Stage 2, and the principle of flexibility would suggest that the form of the institutions, and hence the sort of Treaty change necessary, should not be determined until the point in Stage 1 when it was felt that the transition to Stage 2 was feasible. At that point there would be two options: either comprehensive treaty revision dealing with the changes necessary for both Stages 2 and 3 and with the procedures for passing from one stage to the next, or revision dealing only with changes necessary for Stage 2 with further revision left until it was required.

37 Accountability. Because of the far-reaching transfer of power from member states to the Community as a whole implicit in EMU, very careful consideration would need to be given to the manner in which the institutions to be created were made suitably accountable.