COMMITTEE FOR THE STUDY OF
ECONOMIC AND MONETARY UNION

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III. Concrete steps towards economic and monetary union

1. Principles governing a step-by-step approach

1. The request made by the European Council to the Committee to study "concrete steps" reflects the awareness that an economic and monetary union, as outlined in Part II of this Report, is too profound a change in the economic and institutional structure of the Community to be realised at one stroke. Households, corporations, unions and public administrations will need time to adapt their economic behaviour to a new setting. Similarly, it will not be possible to attribute new powers to the Community at once in all fields. Rather, it will be necessary to build on success and to retain the possibility of correcting the course of action in the light of new experiences.

The ambition, but also the complexity, of the final objective of economic and monetary union reinforce the need to define clearly the process which is to lead to European economic and monetary unification. The present diversity in the situations of the different European countries and the variety of areas involved - which go well beyond the economic and monetary sphere - make it necessary to be both clear and precise concerning the path to be mapped out.

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

(a) Discrete but evolutionary steps

2. The process of implementing economic and monetary union will have to be divided into a limited number of clearly defined stages. Each stage will have to represent a significant change with respect to the

preceding one. New arrangements coming into force at the beginning of each stage will 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 within each stage will apply to both functional and institutional arrangements.

(b) Parallelism.

3. Parallel advancement in economic and monetary integration is an indispensable prerequisite for the avoidance of imbalances which could cause economic strains and loss of political support for the continuing process of developing the Community into an economic and monetary union. Perfect parallelism, however, at each and every point of time is 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 a process of only partial parallelism. A certain amount of temporary deviations from parallelism is part of the dynamic evolutionary process of the Community. However, parallelism has to be maintained in the medium term.

(c) Calendar.

4. The conditions for moving from stage to stage cannot be defined exactly in advance. They depend on too many factors to permit the setting of explicit deadlines. The timing of, especially, the move to irrevocably fixed exchange rates will have to be judged in the light of circumstances by the Council, the Commission and the European System of Central Banks (ESCB), which will have been created in the second stage. A clear commitment to the final stage, as described in Part II of this Report, is however indispensable. There should be a clear indication of the timing of the first step. It could begin [soon after the political decision to draw up a new Treaty has been taken, but at the latest] when the Directive for the full liberalisation of capital movements comes into force on 1st July 1990. [It might be envisaged that this first stage will be completed with the implementation of the single market at the end of 1992.]

~~(d)~~ Indivisibility and gradualism.

5. As has been said above, progress should be both evolutionary and step-by-step. There has to be a balance between the need to make significant steps and the need for gradualism. In achieving this balance it is crucial that at any point in time during the evolutionary process there is no ambiguity about the ultimate responsibility for policy decisions and operational duties. Unless it is unmistakable who (i.e. whether national governments or the Community; which organ or institution) has "the last word", there is a risk of market uncertainty and policy conflict.

The need for a clear definition of ultimate policy responsibility is heightened by the fact that in the process of integration certain decision-making powers, which are presently in the hands of national authorities, will have to be attributed to Community bodies. The most prominent example in this respect is monetary policy. Once exchange rates are irrevocably locked - as was pointed out in Part II of the Report - a common monetary policy is required and will have to be formulated collectively in the framework of the European System of Central Banks. As the authority over monetary policy ~~is indivisible, i.e. it~~ cannot be shared out among several autonomous decision-making bodies, the transfer of responsibility for monetary policy from national central banks to the ESCB must be made in one stroke; moreover, because all operations in domestic money markets and intervention in the foreign exchange market affect monetary conditions, there is no possibility of gradually handing over only certain policy functions or instruments. This implies that until exchange rates are locked the ultimate decision-making power over each Community currency will rest with the respective national central bank.

At the same time, however, if the objective of economic cohesion and the attainment of progressive exchange rate stability is not to be put in jeopardy, the extent to which the national decision-making power can be exercised in practice will be increasingly constrained for all central banks and by force of events will have to take place more and more in a framework of close co-operation and co-ordination. As suggested in the description of concrete steps, collaboration can be greatly strengthened long before the responsibility for monetary policy is actually transferred to the ESCB.

(e) Participation.

6. There is one Community, but not all the members have participated fully in all its aspects from the beginning. So far this has mainly been the consequence of successive enlargements and, for the EMS, of the decision of some countries not to join the exchange rate agreement. 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 on which some member countries join certain arrangements. The management of each set of arrangements should be the responsibility of those who fully participate in it.

2. The Treaty

7. The implementation of economic and monetary union must, in accordance with Article 102A as introduced into the EC Treaty by the Single Act, be embodied in a new Treaty. This Treaty will provide the legal foundation on which the institutional framework of, and concomitantly the distribution of policy responsibilities in, an economic and monetary union, as described in Part II of the Report, will be based.

The Committee has examined the scope for progress in the economic and monetary integration under the legal provisions as they are presently in force in each member country. This investigation has shown that unless national legislations were amended in various respects, there exist narrow bounds for further action on the part of national authorities: no member country is able to transfer decision-making power to a Community body, nor is it possible to set up arrangements for a binding ex ante co-ordination of policies. As a consequence, concrete steps towards economic and monetary union will have to be confined to measures strengthening cooperation ~~collaboration~~, mutual surveillance and analysis of developments and non-binding co-ordination of policies until a new Treaty has been ratified by all member countries.

8. One procedure would be to conclude a new Treaty each time a political consensus to advance one step has been reached. The advantage of this procedure is that it clearly lays open at each step the political

commitment. Its disadvantage is that, as well as being unwieldy and slow, the overall consistency of the process may not be sufficiently safeguarded and sight may be lost of the ultimate objective. It also carries the risk that progress in parallel between the monetary and non-monetary sides would not be respected.

These considerations suggest that a more expedient solution would be to conclude a single comprehensive Treaty which would formulate clearly the essential features and institutional arrangements of economic and monetary union and the steps in which it can be achieved. Such a Treaty could facilitate the implementation process through the provision of "organic laws" and enabling clauses and it could also indicate the procedures by which the decision will be taken to move from stage to stage. Each move would require an appraisal of the situation and [unanimous] political agreement. [Should unanimity be adopted as the rule for all the stages? Who should participate in the decision? The European Council may have to take the final decision, but what say will the organs of the economic institution and monetary institution respectively have in proposing, or giving advice on, the decision?]

3. Concrete steps in three stages

9. The Committee is of the view that the evolution towards economic and monetary union should be divided into three major stages. In each stage a number of concrete and parallel steps would be implemented in the institutional, economic and monetary field which would advance the process of integration, ensure the gradual construction of the institutional framework and reorganise policy responsibilities in accordance with the requirements of an economic and monetary union.

10. ~~In setting out this approach,~~ Both strategical considerations and actual economic developments call for a particularly careful design of the first stage. Firstly, in order to impart a strong momentum to the process of economic and monetary union, and to underpin its credibility, there must be a clear and convincing political endorsement of the final objective reflecting the common political will of all Community countries. Secondly, it must be taken into account that the implementation of the single market programme currently under way will strongly affect the economic environment in the Community. In particular:

- the complete liberalisation of capital transactions by the middle of 1990 is an irreversible process in which the European countries are already engaged. There is a serious risk that in the absence of an explicit procedure to determine the overall monetary policy stance in the Community, national monetary policies will be subjected to different constraints. [In order to avoid such differences it is necessary that the central banks participating in the EMS transform monetary policy co-ordination from an ex post to an ex ante exercise at both internal and external levels;] or alternatively [in order to cope with these problems it is necessary that the central banks participating in the EMS significantly strengthen ~~improve~~ monetary policy co-ordination at both internal and external levels;]
- the sizable fluctuations within the international monetary system have led central banks to rely more heavily on intervention in the foreign exchange markets on a co-ordinated basis. However, such a policy inevitably has a direct influence on the implementation of domestic monetary policies in these countries. It is therefore necessary and urgent that central banks create means for analysing such issues on a permanent and common basis. It is not only a matter of strengthening the impact of their operations, but also of maintaining the efficiency of their monetary management both at domestic and European levels;
- the tendency of the European central banks to conduct in the framework of the EMS their monetary policies ~~[on the basis of differentials vis-à-vis other countries;] or alternatively~~ [with regard to domestic considerations ~~conditions~~ in their respective countries] is not necessarily conducive to fostering a monetary policy satisfactory for the Community as a whole. The creation of a [common monetary think-tank] ~~[monetary policy committee]~~ for analysis and recommendations would make it possible to address this problem better. The deliberations within this [monetary think-tank] ~~[committee]~~ would in effect provide all the central banks with a better basis for setting their own national approaches in a European context while preserving full decision-making autonomy.

The desirability of a clear demonstration of a common political will and the challenges of market integration call for substantial and effective steps at the beginning of Stage I, although, as noted earlier, the scope for practical measures will be limited as long as a new Treaty has not yet been ratified. For this reason it is crucial that Stage I is introduced by the political decision to embark immediately on, and to conclude as quickly as possible, intra-governmental negotiations on a Treaty, as well as a set of concrete measures aimed at effectively enhancing policy co-operation and co-ordination. In summary,

~~4. The three stages~~

10. ~~The following three stages are distinct in several significant respects.~~ The first stage is characterised by two principal features: the decision by the Heads of State and Governments to commence negotiations on a new Treaty and various steps designed to improve policy co-ordination within the framework of the existing institutional arrangements. The responsibility for policy decisions as well as the operational procedures for implementing policies would remain unchanged.

11. The second stage would begin after the Treaty has been put into effect~~, provided that during the process of Treaty negotiation and ratification all Community countries have joined the exchange rate mechanism of the EMS on an equal footing~~. This would involve the construction of the institutional framework of the economic and monetary union and, where envisaged, a gradual transfer of operational functions to the Community institutions. This stage would be characterised primarily by a training process leading to a collective decision-making, without, however, yet abandoning the ultimate responsibility for policy decisions at the national level.

12. The final stage would commence with the move to irrevocably locked exchange rate and the attribution of those competences to Community institutions that have been described in Part II of the Report. In the course of the final stage the national currencies would eventually be replaced by the ECU as the Community's sole currency.

4 ~~3.~~ The principal steps in stage one

13 ~~11.~~ <u>In the institutional field</u> this stage would involve the preparation and ratification of the Treaty on the economic and monetary union, with a procedure similar to the one followed for the Single European Act. The decision to draw up a Treaty would be coupled with an official announcement that the ECU would be the currency of a future monetary union in Europe.

14 ~~12.~~ <u>In the economic field</u> the steps would centre on the completion of the internal market programme, the reform of the Community's regional policies and efforts to strengthen co-ordination of national budgetary policies. In particular, there would be:

- complete removal of internal barriers and liberalisation of exchanges of goods, services and capital within the Community, according to the ~~single~~ internal market programme adopted in the Single Act; strengthening of Community competition policy and of the executive and judicial authority to identify and sanction infringements of Community law;
- full implementation of the "Brussels package" for reforming and doubling the structural funds, designed to strengthen substantially the ability of Community policies to promote regional development and to correct economic imbalances;
- replacement of the 1974 Council Decision on economic convergence by a new procedure for an increasing degree of budgetary policy co-ordination. The thrust of the revision of the 1974 convergence decision will be to strengthen considerably the possibilities for reducing fiscal imbalances, as well as for improving the assessment of the overall policies of the Member States in the light of both their economic and social consequences and their consistency. The assessment will 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. In particular, the revised 1974 convergence decision would:

- set up a new procedure for budgetary policy co-ordination, with increasingly precise quantitative guidelines, where appropriate, and medium-term orientations; and a programme for member countries concerned to consolidate their budgetary position [by reducing, where necessary, the central government deficit to no more than X% of GNP over a period of Y years];
- establish a process of 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 at the Community level recommendations and endorsements to correct national policies;
- provide for the possibility of promoting, where felt appropriate, concerted actions of the member countries.

15 ~~13.~~ In the monetary field focus would be placed on intensifying co-operation and co-ordination of monetary policies and efforts to include all Community currencies in the narrow band of the EMS exchange rate mechanism. Realignments of exchange rates would remain one of the instruments for adjustment of imbalances among Community countries. In particular, there would be:

- the full implementation of an integrated banking and financial market in the Community in accordance with the internal market programme;
- the completion of the EMS in the sense that all Community countries would join the exchange rate mechanism and observe the same margins of fluctuation;
- the removal of regulatory impediments to the voluntary use of the ECU as a common numeraire and a means of settlement by private economic agents;
- the replacement of the 1964 Council Decision defining the mandate of the Committee of Central Bank Governors by a new decision giving the Committee greater authority and visibility and making it the forerunner of the Council of the European System of Central Banks to be created under the new Treaty. The thrust of the revision of 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 be invited to:

- 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 be consulted in advance of national decisions on the course of monetary policy, such as the setting of annual domestic monetary and credit targets; ~~or alternatively [formulate a recommendation on the overall orientation of a monetary and exchange rate policy, as well as on measures taken in this field by individual countries. In particular, the Committee would be consulted in advance of measures or decisions on the course of monetary policies, such as the setting of annual monetary and credit targets.~~ The Committee could declare publicly, in the event of speculative capital flows unwarranted by fundamentals or underlying monetary policy, that the European central banks stood ready to counteract these capital flows by interventions;
- make policy recommendations to individual governments and the Council of Ministers on non-monetary 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;
- the Committee's opinions and recommendations would not have to reflect unanimity, but could be established by a qualified majority; the recommendations would not be binding;
- set up three committees (supported by a permanent research staff) which would report regularly to and advise the Committee of Governors. A monetary policy committee would define common surveillance instruments, propose harmonised objectives and help to develop gradually a process from ex post analysis to an ex ante approach to monetary policy

possibly

[Should these two committees be merged into a single one?]

adjustment; a foreign exchange policy committee would monitor and analyse exchange market developments and assist in the search for effective intervention strategies; a committee on banking supervision would undertake regular consultations on matters of common interest in this field;

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

16. A number of Committee members advocated the creation of a <u>European Reserve Fund (ERF)</u> that would foreshadow the future European System of Central Banks. The main objectives of this institution 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 eventually 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 require a permanent structure and staff in order to achieve its tasks, i.e.:

- management of the pooled reserves;
- interventions on the exchange markets 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 that both require a common approach of the central bank concerned.

The management of the ERF would consist of:

- a Board of Directors which would comprise automatically 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 of a small size, consisting of three or four members who would have direct responsibility for the different departments of the ERF;
- the two Committees: a Foreign Exchange Policy and a Monetary Policy Committee;
- two departments: a Foreign Exchange and Reserves Management Department, and a Monetary Policy Department.

17 ~~15~~. Other members of the Committee felt that the creation of a ERF was not opportune at this stage. Their reservations stem from the fact that:

- too much emphasis is placed on external considerations, giving support to the illusion that common interventions by such a Fund cannot be a substitute for economic adjustment to correct ~~would strengthen intra-EMS exchange rate cohesion notwithstanding the existence of~~ imbalances within the Community or would offer individual countries more leeway in their domestic monetary policy;
- the proposal involved an institutional change which, in accordance with Article 102A of the amended EC Treaty, would fall under the stipulated procedure of Article 236 and require a new Treaty; the setting-up of the Fund under the same procedures that were applied to the establishment of the EMS was not considered possible;
- it would be counterproductive to set up a new institution for a limited period of time, in particular if most of the functions of the Fund could be performed by a strengthening of the Committee of Governors;
- it would institutionalise the separation of the Community into two groups of countries.

However, the Committee members opposed to the immediate creation of the ERF could envisage some pooling of reserves and intervention operations at a later stage, but before the definite locking of parities.

5 ~~6~~. The principal steps in stage two

18 ~~16~~. In the institutional field the basic organs and ~~institutional~~ structure of the economic and monetary union would be built in accordance with the Treaty, 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 analysis of macro-economic developments and promote a process of common decision-making, although the ultimate policy responsibility would still remain in the hands of the national authorities.

19 ~~17~~. In the economic field the Council of Ministers and the Commission [with some involvement of the European Parliament?] would assume a greater role in promoting convergence and co-ordination of economic policy in the Community. To this end the following steps would be taken:

- introduction of progressively more precise rules relating to the size of the budget deficits and their financing;
- adoption of medium-term guidelines for key financial targets and economic programmes in the member states;
- joint adoption of budgetary objectives, when felt appropriate, as part of a co-ordinated budgetary and economic policy;
- enlargement of resources for supporting the structural policies of the Member States and strengthening the Community investment programmes in the fields of research and infrastructures.

20 ~~18~~. In the monetary field the European System of Central Banks - having all the principal features described in Part II of the Report - would be set up and absorb the previously existing institutional monetary arrangements (EMCF, Committee of Governors, the committees for monetary policy analysis, foreign exchange policy and banking supervision, and the permanent Secretariat). The most important feature of this stage is that the functions of the ESCB in both monetary policy operations and the

formulation of a common monetary policy would gradually evolve as experience is gained in managing monetary policy in the Community. Exchange rate realignments would remain an instrument of adjustment, but there would be an understanding that the frequency and the extent of realignments should be continuously reduced.

- [initially the ESCB framework would be used: as a joint facility which national central banks would share in 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; as a centre for the co-ordination of national monetary policies;
- in the course of this stage the ESCB would become the interface between the national central banks and the Community's money markets, with the entire monetary operations of individual national central banks being reflected in their transactions with the ESCB;
- the progress in joint monetary policy operations would be strengthened in the course of this stage by the pooling of a certain amount of exchange reserves and the conduct of limited exchange market interventions by the ESCB in accordance with guidelines established by the ESCB Council;
- in the course of this stage the process of co-ordinating national monetary policies would be reinforced by the setting of general monetary targets for the Community as a whole, with national monetary policy being executed in accordance with these global guidelines;
- towards the end of this stage the enforcement of an overall monetary policy in the context of the ESCB could be strengthened by the use of the ECU as a reserve instrument issued by the ESCB.]

6 ~~7~~. The principal steps in stage three

21 ~~19~~. In the institutional field there would be the full attribution of competences to Community institutions, as foreseen in the Treaty.

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~~20.~~ In the economic field the Council of Ministers and the Commission [in co-operation with the European Parliament] would have the authority:

- to impose constraints on national budgets to the extent to which this is 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 propose discretionary changes (through a procedure to be defined) in the level of harmonised taxation rates;
- to apply some form of conditionality to existing Community structural policies and to Community loans (as a substitute for the present medium-term loans facility).

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~~21.~~ In the monetary field the irrevocable locking of exchange rates would come into effect and the ESCB would fully assume its responsibilities as foreseen in the Treaty. In particular:

- concurrent with the announcement of irrevocable fixing of parities between the Community currencies, the full responsibility for the formulation and implementation of monetary policy in the Community would be attributed to the ESCB Council;
- decisions on exchange market interventions in third currencies would be made entirely under the responsibility of the ESCB Council in accordance with Community exchange rate policy; the execution of interventions would be entrusted to [one or ?] national central bank.