PART III

"CONCRETE STEPS" TOWARDS THE ECONOMIC AND MONETARY UNION

1. Problems and Principles

This part of the Report could start with some considerations about the problems and principles concerning a strategy of approaching the economic and monetary union by steps. General considerations could be made on the following issues:

Gradualism and indivisibility: an economic and monetary union as oulined 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, 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 correct 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 or the Community level; what 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 economic and monetary union will be lost. In its past successful developments the Community has combined the two principles of gradualism and indivisibility in various ways: by shifting certain competences and not others (e.g. VAT as the common scheme for indirect taxation, with rates setting left to national governments), or by advancing in certain areas (e.g. the custom union) faster than in others (like the harmonization of legislation), etc. 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. For monetary policy a relevant question is to what extent the determination of monetary policy is a divisible function.

Parallelism and disequilibria: 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 counter-productive. Advancement in one area may trigger advance-ment in others. The EMS has contributed to a greater economic convergence that has favoured capital market liberalization and the programm of completing the internal market. A certain amount of temporary disequilibrium may be part of the dynamic process of the Community. Parallelism has to be maintained in the medium term.

Multiple speeds: there is one Community, but not all the members participate in all its aspects at every point of time. So far this has mainly be the consequence of successive enlargements and, for the EMS, of some countries not 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 be entered by some member states. For each set of arrangements the management of it should be the responsibility of those who fully participate in it.

<u>Calendar</u>: an exact deadline has been unsuccessfully announced in the Werner report in 1970. The Committee may consider that the conditions for reaching the conclusion of the process are too difficult and depend on too may factors to permit a firm announcement of an explicit deadline. A clear commitment to the final goal and to fundamental features of it as described in Part I, however, may be indispensable, and so the indication of the timing of at last the first step. Moreover, it has also to be observed that the so called "final stage" is not necessarily a stage beyond which the system will not have further evolution. Rather, it has to be seen as 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. Thus a flexibility in the calendar is necessary.

<u>Moving from one stage to the next</u>: it will be necessary to indicate the procedures whereby the decision will be taken to move from one stage to the next, particularly when no clear dates are set in advance. On the one hand, the decision to engage in the process proposed by the Report will represent a single political decision embracing the whole enterprise and committing to it. On the other hand every passage from one stage to the next will require an appraisal of the situation and a political agreement.

On the basis of these considerations 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 whole process would be designed in a treaty, that, like the Treaty of Rome, would define an objective and set the rules to achieve it. Within the treaty several steps would be defined in their content and in the procedures to implement them;

(ii) continuity in the objectives. The objectives of the process would be the same throughout the various stages. Each stage would represent one step in approaching them;

(iii) shaping the legal base and the institutions at the outset, gradual transfer of competences (cercare un miglior titolo): the organs of the economic and monetary union would be established at the beginning, with all the institutional safeguards and characteristics that are deemed necessary. Through various steps increasing competences would be attributed to such institutions. The container would be created at the outset, the content would be poured in gradually;

(iv) distinction between economic and monetary arrangements: the creation of a monetary union requires the establishment of a new institution that would have to be given a proper place in the existing constellation of Community institutions (Council of Ministers, European Parliament, Commission, Court of Justice); the economic union, instead, may only require suitable changes in the functions and responsibilities of institutions that already exist. While a degree of parallelism and inter-dependence between monetary and economic developments towards the union is required, the two sets of institutions should remain separate, to ensure from the outset the prevailing objective in the conduct of monetary policies is the stability of the value of currency.

2. The content

The content of an economic and monetary union as described 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 a small number of 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 outline 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 to this freedom; 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 program 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 necessary to support the integrated internal market, the Community has to increase the effectiveness of the process whereby the Community law is enforced;

ii) <u>arrangements to foster economic adjustment in conditions in which the possibility of adjustment through the exchange rate will gradually disappear:</u> 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 the maximum 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 ... 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 be extended and made more effective and 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. 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 (should the Report put forward a proposal for 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 Movement leading to monetary union.

The monetary union will be the result of progess 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, unicity of monetary policy. For each of these fields, the report could outline the evolution leading to a monetary union along the following lines:

i) irreversible convertibility of currencies: convertibility of currencies is now fully established for Community countries. To make it legally irreversible requires Community legislation .... (prego Saccomanni di verificare) .... ;

ii) 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;

iii) 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 stronger function of prudential controls exerted at the Community level, at least in the banking field, which is closest to monetary policy. The system of European central banks 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;

iv) irrevocable locking of parities: Part I will have described how operates the system of parities irrevocably fixed by construction of the final stage of the monetary union. Here the report will have to indicate what intermediate steps are possible and advisable to approach such system from the "fixed but adjustable" regime of the EMS. Such steps may 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. The problem here is 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 monetary policy decision-making process whereby the money supply of the Community is managed in common as a total, with the aim of providing a "domestically stable" currency to the union. The difficult problem, here, is that the process of moving from many national monetary policies to one common policy may not be really divisible in steps. To try to do so 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 problem would be one of preparing this step, for instance by improving and deepening the process of <u>ex ante</u> consultation, and when to take this step. Perhaps the right moment is in coincidence with the "irrevocable locking" of parities.

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 these 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.

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

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

3. Three steps

In the previous paragraph the evolution leading to an economic and monetary union was described as a sort of continuous movement, although it was recognized that jumps may be inevitable at certain points. However, the request made by the European Council to the Committee to study "concrete steps" reflects the fact that, for reasons that are both logical and practical, the process will have to be divided into a limited number of clearly defined stages, corresponding to different functional and institutional sets of arrangements, concerning the various areas. 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.

The sequence of steps has to be logical, as well as chronological. This means that each step has to contain a set of measures and arrangements that, while inevitably incomplete and not perfectly equivalent in all the policy areas concerned, are sufficiently balanced to reduce the risks of creating situations that are difficult to manage and that would endanger rather than help the attainment of the final goal of the union.

At the time this outline is drafted the Committee has devoted some time to the discussion of the final stage (described above in Part I) and to the content and organization of a possible first step. What follows here 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 phases about which the Committee has already discussed. Such an hypothesis is presented with the intention to stimulate further discussion in the Committee.

The content of the three steps could be the following:

i) 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)....;
- a new procedure for fiscal policy coordination replacing the one set by the 1974 decision on economic convergence.

In the monetary field:

- creation of the Monetary institution, (N.B. the Monetary institution and the Economic institution, mentioned below, will have been described in Part I) which would inherit the present EMS and monetary arrangements (EMCF, Committee of Governors, competence over the ECU, etc.);
- definitive pooling of a certain amount of reserves to conduct interventions in external currencies (dollar, yen);
- a mandatory ex ante consultation about domestic monetary policies;
- ex ante consultation in the matters of common interest concerning banking supervision;
- narrowing of margins of fluctuations from 2.25 to 1 (?) per cent.

ii) Stage two:

In the economic field:

- creation of the Economic institution;
- introduction of binding restrictions to the external borrowing and monetary financing to cover domestic budgetary deficits;
- 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 be exerted by 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?

iii) Stage three (final stage; this will have to be consistent with what is said in Part I):

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.

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).

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 steps. 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 steps, 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.

Moving from one stage to the next. 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?

Location. 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 be located the monetary institution?

TPS
2.11.88