7th November 1988

The final objective: economic and monetary union

I. Introduction

The establishment of an economic and monetary union represents the final stage in the progressive process of economic integration in Europe. With the completion of this ultimate objective, the Community forms an area in which all residents can engage freely and without impediment in any kind of economic activity, subject only to commonly applied or mutually recognised rules and regulations and economic policies geared towards price stability, balanced growth and converging standards of living, high employment and external equilibrium.

Economic and monetary union thus means that the Community is transformed from a set of independent - though interdependent - national economies into a single economy, with the same basic features that circumscribe the existing national economies: a single currency area, a single market and an institutional framework for economic policy management. At the same time, however, an economic and monetary union in Europe will differ fundamentally from existing economies in one important respect: made up of independent, historically grown nations with different levels of economic development and differing traditions, social customs and languages, the Community will remain much more heterogeneous than any of its constituent economies. It is precisely this difference which does not allow simply to model Europe's economic and monetary union on any of the existing economies but makes it necessary to develop an innovative and unique solution.

In its search for this solution and its progressive implementation, the Committee was of the view that any step-by-step approach to the final objective could be set out only if there was a clear understanding of the meaning of economic and monetary union, its implications for economic working and decision-making and the principal elements that had to be in place for its successful and durable functioning. Economic union and monetary union form two integral parts of an entity and it is only for reasons of expositional clarity that in the following sections a distinction is drawn between them.

II. The principal features of monetary union

A monetary union implies the creation of a single currency area, i.e. an area in which one or several currencies serve as a means of payment, unit of account and store of value for all residents of that area. Whether these traditional functions of money are fulfilled by a single currency or simultaneously by a number of national currencies has important symbolic and operational consequences. In substance, however, the two possibilities cannot differ if a genuine single currency area is to be established. The co-existence of national currencies is therefore only compatible with the concept of monetary union if each of the freely circulating currencies has lost its particular "identity", in the sense that in the eyes of market participants all currencies are of equal quality and standing. Only under this condition will all currencies be perfectly substitutable, i.e. they simply represent different denominations of "the" currency of the union, are interchangeable without costs and are used and accepted in transactions throughout the union in the same way that different bills of a currency are used and accepted in a national economy. This situation is reached when interest rates on the same type of financial instrument are identical, irrespective of the fact in which of the circulating currencies the instrument is denominated.

For this objective to be realised, several conditions have to be met. The Committee agreed that the three requirements mentioned in the 1970 Werner Report:

- total and irreversible convertibility of currencies;
- elimination of margins of fluctuation and irrevocable locking of exchange rates; and
- complete liberalisation of capital transactions and full integration of banking and other financial markets,

are indispensable elements of a monetary union. The Committee is, however, also of the view that these macro-economic requirements alone do not necessarily ensure perfect substitutability between all currencies in the Community. The continued existence of national currencies - even if intended for purely symbolic reasons - could cast doubt on the member countries' commitment to unchangeable exchange rate parities and thus engender divergent assessments of individual currencies in the market place. Furthermore, even if fluctuating margins have been abolished, the exchange of one currency for another entails costs for commercial banks and could give rise to bid/offer spreads. Both considerations suggest that the macro-economic requirements do not eliminate automatically the possibility of interest rate differentials which are inconsistent with monetary union. Moreover, each currency can fulfil all monetary functions throughout the union only if it is recognised as legal tender in each member country. For these reasons the Committee [advocates ...].

A monetary union affects profoundly economic performance and has far-reaching consequences for the management of monetary policy in the Community - changes which entail both costs and benefits. On the positive side, a first advantage is that exchange rate uncertainties are eliminated and that the costs of transactions between residents of different countries of the Community are lowered, thereby imparting stimulatory effects to trade and growth. In the same vein, movements of exchange rates unwarranted by fundamental factors can no longer be a source of macro-economic disturbances and competitive distortions. The locking of exchange rates in combination with an unrestricted single market also implies that trade between residents of different countries of the Community represents a domestic (and not an external) transaction - with the result that the Community as a whole is much less open and less susceptible to external shocks than any of its member countries. Finally, if it is firmly believed that exchange rates are permanently fixed, market participants in all countries are likely to behave more conformably and thereby contribute to the evolution of a more homogeneous economic structure in the Community.

These benefits are, however, counterbalanced by certain economic costs. The most serious drawback of a monetary union is that the exchange rate ceases to be an instrument for adjusting economic imbalances among member countries, shifting the need for adjustment to other market mechanisms and, as discussed in the next section, necessitating significant safeguards in non-monetary policy areas. Moreover, with exchange rates locked and national currencies being perfect substitutes, the concept of national balances of payments of member countries is no longer meaningful, with the consequence that two important sensitive indicators of disequilibria between countries - the exchange rate and the balance of payments - are no longer available as guideposts for national policy-making.

In a system of fixed exchange rates and freely circulating identical currencies, there is no scope for independent national monetary policies. Any attempt to pursue such a national policy would destroy the foundations of the monetary union. The final objective can therefore be realised only if the Community countries consent to having <u>one</u> monetary policy and, by implication, <u>one</u> exchange rate policy vis-à-vis non-Community currencies. This implies that all member countries agree on the objectives of monetary policy, applicable to the Community as a whole.

Both the necessity to base monetary policy on a collective decision-making and the operational nature of monetary policy, i.e. the need to respond quickly to changing market conditions, imply that in the final stage the authority over monetary policy has to be centralised in one new institution, even if the execution of policy measures is shared among a number of national central banks. The Committee is firmly of the view that such a European central bank system can only fulfil its task and ensure the cohesion and stability of the union if it is built on the following principles:

- a mandate to maintain stability of the value of money as the prime objective of European monetary policy;
- independence from national governments and Community authorities;
- voting power based on the economic importance of the member countries;
- a federal structure;
- limitations on credit that can be granted to public authorities, including those of the Community;
- policy instruments capable of managing the money supply effectively without recourse to quantitative controls;
- responsibility for banking supervision.

III. The principal features of economic union

In a narrow sense, as is already pointed out in the Werner Report, economic union describes an area within which persons, goods, services and capital can move freely and without distortion of competition. However, if economic union is to co-exist with monetary union, it forms part of an entity, which, much in the same way as in a national economy, must possess arrangements that allow an effective policy-making and the realisation of broadly similar economic conditions and standards of living. In this sense economic union encompasses a much wider concept.

The Committee agrees that the existence of an unrestricted single market constitutes a crucial element of economic union. In creating a "level playing field" for all residents of the Community, the single market ensures that decisions on production, investment and consumption are made in broadly similar conditions and on the basis of similar levels of information. To this end all barriers which tend to separate markets along national borders have to be eliminated. This implies in particular that all technical and regulatory obstacles are removed, standards are harmonised or mutually recognised and that tax treatment does not discriminate economic activities across Community countries. The Committee felt that these aims can only be realised if the authority over competition and industrial policies is transferred effectively to the Community, thereby ensuring a collective decision-marking about - and a uniform application of - the appropriate standards and regulations. Given that certain aspects of social policy, as well as consumer and environmental protection, can influence significantly competitive conditions, certain minimum standards in these fields also have to be laid down at the Community level. Finally, a single market requires that all forms of taxation affecting the flow of goods and services do not provide differing incentives to economic activity in individual member countries - unless such incentives are deliberately part of the Community's regional or structural policies. An effective functioning of the single market, however, also requires that the Community is put in the position of supervising the adherence to common standards and is therefore given the executive and judiciary authority to enforce compliance in all member states.

The need for additional arrangements beyond those associated with the establishment of the single market stems from the fact that the freedom of movements of persons, goods and services and capital in conjunction with a monetary union has important implications for the working and the management of the economy of the Community. Most importantly, adjustment of economic imbalances among member countries can no longer be supported by exchange rate realignments and alternative balancing mechanisms have to be found and the risk of imbalances has to be reduced. Moreover, the single market tends to aggravate the differences between Community countries with higher and lower levels of economic developments and could possibly produce economically and politically undesirable dislocations of industries and labour forces. Finally, in an environment of a free market and a monetary union there is a serious danger that unco-ordinated national budgetary policies generate intra-Community imbalances, undermine monetary policy and render it difficult, if not impossible, to pursue macro-economic policies for the Community as a whole.

In the view of potential policy conflicts and the disturbances from intra-Community imbalances, the Committee felt that economic union has to have at least three additional features safeguarding its functioning in concert with monetary union.

Firstly, an economic union requires a set of measures to enhance the effectiveness of market mechanisms and to strengthen self-regulatory market forces in order to cope with imbalances that could emanate from excessive wage claims in one member country or from external shocks with differing repercussions on individual economies. The creation of the single market represents an important step in this direction but complementary action is needed to increase greater wage and price flexibility, ensure wage setting procedures based on productivity developments and strengthen the regional and occupational mobility of labour. [Reference to income policies? Institutional arrangements describing the respective roles of the Community and national governments?]

Secondly, an economic union requires adequate arrangements to address the problem of structural differences between Community countries and the concomitant disparities in levels of per capita income. The Committee felt that without adequate safeguards in this area market forces would - at least in the short run - exacerbate rather than mitigate the differences between poorer and richer member countries and lead to intolerable strains and frictions in the Community. For this reason an economic union must possess a system of financial transfers aimed at both tempering existing inequalities of standards of living and actively promoting structural development in countries with low per capita incomes. The effectiveness of the system of transfers is partly a question of its endowment with financial resources, but also of the systems' ability to implement effective programmes for the improvement of the productive capacity through investment in such areas as physical infrastructure, communication and education.

Thirdly, an economic union is incomplete without functional and institutional arrangements that allow a close and flexible co-ordination of national budgetary policies - at least, as long as the Community's budget has not reached a critical size. The aim of this co-ordination is twofold. Firstly, it must help to avoid those differences between member countries' budgetary positions which could generate imbalances in real economy of the Community or in its financial market. To this end, as a minimum, national authorities have to accept limitations on foreign borrowing (outside the Community) as well as on monetary financing of budget deficits. Whether additional formal constraints are needed depends to a significant extent on the disciplinary pressure that financial markets impose on the budgetary behaviour of public authorities. The greater such market constraints the lesser is the need for binding rules on individual countries' scope for budget deficits. The second reason why national budgetary policies need to be co-ordinated is to enable the Community to formulate an appropriate macro-economic policy mix.

[Institutional arrangements; indirect and direct transfer of national authority to Community body?]

IV. The interdependence of economic and monetary union

Economic union and monetary union form two parts of a single entity and consequently there is a close interdependence between the economic and monetary requirements outlined in the previous sections. This interdependence has three important implications for the progressive implementation of the final objective, discussed in detail in Part III of the Report.

Firstly, beyond a certain point of integration additional steps are only meaningful if it is the intention to implement fully all elements describing the final objective. Stopping short of this aim would not only produce a sub-optional solution if measured against the final objective, but might in fact be less optimal than a lower level of economic integration.

Secondly, while there is no doubt that the benefits of economic and monetary union will by far outweigh its costs when the final objective is achieved, on the way towards the objective benefits may not always exceed costs.

Thirdly, the success and the sustainability of the implementation of the various elements of economic and monetary union hinges critically on combining steps and progressive integration with adequate safeguards.