Draft
CSEMU/6/88

Skeleton of Report 14th December 1988

III. Concrete steps towards economic and monetary union

1. Principles governing a step-by-step approach

The ambition, but also the complexity, of the final objective of economic and monetary union reinforce the need to [clearly] define 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.

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.

For these reasons 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.

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 step-by-step approach to economic and monetary union.

A first consideration concerns gradualism and indivisibility. While the arguments above point to the need for gradualism, it has to be recognised that, in certain specific areas, policy decisions and operational responsibilities cannot be transferred "piece by piece" but require a quantum jump. Unless it is clearly indicated who (i.e. whether national governments or the Community; which organ or institution) has "the last word", policy conflicts will inevitably arise. However, ... In the following, two alternative scenarios are presented, corresponding to different choices concerning gradualism and indivisibility.

A second and related consideration concerns parallelism. Parallel advancement in many interrelated areas is an indispensable prerequisite for the avoidance of imbalances which could cause economic ~~disruptions~~ 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 been combined 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.

A third consideration concerns participation. 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

calendar is necessary. However, a clear commitment to the final stage, as described in Part II, is indispensable and there should be at least an indication of the timing of the first step. Progress from one stage to the next will require that the monetary authorities are in full agreement not only on the medium-term direction in which they must aim their efforts and initiatives in the monetary field, but also on the day-to-day implementation of the specific policies they have to define and co-ordinate.

2. How to proceed?

The implementation of economic and monetary union must, in accordance with Article 236 of the Treaty of Rome, be embodied in a new Treaty. However, even after a political decision to conclude a new Treaty has been taken, its drafting and ratification will require a certain time. In order not to lose momentum and to demonstrate the political determination to advance on the road to economic and monetary union, it would seem advisable to combine in a first stage the conclusion of the new Treaty with the enactment of a number of concrete measures. While the possibilities for action will have to conform with the existing legal and institutional framework of the Community, the Committee feels that there is sufficient scope for additional and meaningful measures in both monetary and non-monetary areas. However, some of these measures may, as described in the next section, require some changes in national legislations. The new Treaty would come into force at the latest at the end of the first stage of the process.

Concerning the Treaty, two alternative routes are conceivable. The first route is to conclude a new Treaty each time a political consensus to advance one step has been reached. This procedure has the advantage of clearly laying open at each step the political commitment to European integration and offering a high degree of participation of national governments. At the same time, however, this approach is not only rather unwieldy and bound to be slow, it also carries the risk that, with focus on pragmatic considerations, the overall consistency of the process may not be sufficiently safeguarded and sight may be lost of the ultimate objective. Moreover, while there is no doubt that upon completion of the process of integration all countries will benefit greatly from economic and monetary

union, each time a decision on a new step is to be made without a firm view of the ultimate goal short-term cost considerations may receive undue weight against longer-term benefits and thus hamper the process of integration.

An alternative route would consist in concluding a comprehensive single new Treaty which would formulate clearly the essential features and institutional arrangements of economic and monetary union as described in the preceding sections. The Treaty would facilitate the implementation process through the provision of "organic laws" and enabling clauses. The Treaty would then serve as a visible landmark on the way to integration against which the consistency and conformity of each individual step with the final objective could be checked. Such a procedure would allow all member countries of the Community to express their agreement with the final objective of European integration while, at the same time, it would not necessitate that each step be carried out simultaneously by all countries, thus leaving room for longer transition periods for certain countries.

Taking these considerations into account the Committee feels that a step-by-step approach should be founded on two basic principles:

(a) whether it be at the monetary or economic level, it would be necessary rapidly to reach ratification of a Treaty, which would have the double advantage of:

- setting the initiatives taken in the intermediate phase very definitely and irrefutably in the context of the path laid down towards the ultimate aim of monetary and economic union. This is essential for the integrity of the final objective to be ensured and also for the process to maintain its momentum and make steady progress;
- respecting the principle of progress in parallel with that achieved in the non-monetary fields, which should also be the subject of a Treaty. This would have the effect of reinforcing these other commitments, which would ensure that the emphasis in these initial stages would not fall entirely on monetary and foreign exchange policy.

(b) The Treaty will indicate the procedures whereby the decision will [illegible] On the one hand the signing

convergence decision will be to strengthen considerably the possibilities for an assessment and ~~a better~~ implementation of the overall policy mix in the Community. 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 will:

- set up a new procedure for budgetary policy co-ordination, with quantitative guidelines, where appropriate, and medium-term orientations;
- 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;
- contain a ~~commitment by all~~ programme for concerned member countries 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].

In the monetary field:

- capital transactions: the coming into force of the June 1988 directive liberalising monetary movements in July 1990 will establish a regime of complete freedom of capital transactions. During this first stage a directive would be adopted to harmonise tax treatment of capital revenues to the extent that is necessary to avoid distortions in capital flows;
- 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 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 will be to strengthen further the co-ordination of monetary policy among all member countries of the Community. To this end, the Committee will 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;
- 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;
- 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.

In order to enhance its role in the process of monetary policy co-ordination:

- the Committee's opinions and recommendations would not have to reflect unanimity, but could be established by a qualified majority [determined on the basis of weighted votes?]; the recommendations, would not be binding;

- the Committee would be chaired by a Chairman who would be elected for a period of [three] years;
- the Committee would be supported by a permanent Secretariat.

- EMS arrangements: all member countries would become participants in the exchange rate mechanism of the EMS with the same fluctuation margins; [~~mechanisms of financial support~~ would be strengthened to make the system ~~fully~~ better equipped to counter, if needed, destabilising short-term capital movements;] margins of fluctuation would be narrowed from 2.25 to [1]%;
- ECU arrangements: removal of regulatory impediments that may prevent market participants using the ECU in setting prices, keeping corporate accounts, and contracting, any kind of pecuniary obligations. The ECU remains a basket.

A(2) Stage two

(to be enacted when the new Treaty comes into force.)

In the economic field:

- the Centre for economic policy decisions (CEPD) would start operating with a view to promoting convergence and co-ordination of economic policy in the Community. [Following the programme set out in the new Treaty, legislative and executive measures would be taken, at the Community as well as the national level, leading to the creation of a European Fiscal Framework (EFF). Such a system would cover: essential tax harmonisation; the respective roles of national and Community budgets; "own" resources of the Community budget; the size of budget deficits and their financing;]
- [in accordance with the programme for the EFF,] this stage would include:

- introduction of 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.

In the monetary field:

- creation of the European system of central banks (ESCB) described in Part II of this Report, with its ~~central body (the Federal European Monetary Institution - FEMI)~~, decision-making organs (Board and Council), balance sheet, and legal underpinnings: mandate to preserve price stability, independence, accountability, decision-making procedures. The ESCB would replace the present institutional monetary arrangements (EMCF, Committee of Governors and its permanent Secretariat). The ESCB would be endowed with a certain proportion of gold and third currencies, previously held as foreign exchange reserves by national central banks, as well as certain contributions of national Community currencies.

The tasks of the ESCB would be:

- to act as a forum for [binding] ex ante co-ordination of national monetary policy, with monetary policy being executed by national central banks. The co-ordination would take place in the ESCB Council, which in addition, would take over the functions performed in stage one by the Committee of Governors. The ESCB Council would be supported by a permanent staff (which

replaces the permanent Secretariat set up in stage one), and the staff would be supervised by the Board;

- to conduct [limited] exchange market interventions, both in third currencies and within the EMS [in concertation with central banks whose currencies were used? In accordance with guidelines established by the Council?];
- to represent the Community (together with representatives of national central banks) in international monetary meetings;
- to manage its holdings of third currencies and national Community currencies;
- to administer the short-term and very short-term financing mechanisms;
- to administer the private ECU clearing system.

[N.B. Owing to the small size of ~~EMCF~~ ESCB interventions and to the firm control exercised by ~~the~~ its Council ~~of the EMCF~~, the impact of ~~EMCF~~ these operations on domestic monetary conditions of member countries should be negligible. Its main function would be to provide a signal to the market.]

A(3) Stage three

~~This~~ corresponds to the final stage described in Part II. It should be observed that the so-called "final stage" is not necessarily a stage beyond which the system would not be susceptible to further evolution. Rather, it is one in which the fundamental requirements of an economic and monetary union would have been fulfilled, albeit in a setting that might be subject to changes and improvements.

In the economic field:

The Centre for economic policy decisions would be given the authority:

- to impose constraints on national budgets when 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 make discretionary changes (through a procedure to be defined) in the level of harmonised taxation rates;
- to apply some form of conditionality to existing Community budgetary transfers and to Community loans (as a substitute for the present medium-term loans facility).

In the monetary field:

- ~~the beginning of this stage would be marked by the~~ announcement of irrevocable fixing of parities between the Community currencies;
- concurrently the full responsibility for the formulation of monetary policy in the Community would be attributed to the ESCB ~~FEMI~~ Council, replacing the [binding] ex ante co-ordination procedure followed during the preceding stage;
- decisions on exchange market interventions in third currencies would be made entirely under the responsibility of the ESCB ~~FEMI~~ Council; the execution of interventions would be entrusted to [one or ?] national central banks;
- the implementation of the Community's monetary policy would be carried out by the Board of the ESCB ~~FEMI~~ in co-operation with national central banks. In order to be able to influence overall monetary developments in accordance with the decisions of the ESCB ~~FEMI~~ Council, the Board ~~FEMI~~ would be empowered both to impose and vary minimum reserves [in ECU; national currencies, third currencies?] to be held by national central banks and to operate directly in the money markets.

A(4) Last stage

- the ECU replaces national currencies.

Scenario B

B(1) Stage one

(to be enacted in conjunction with the coming into force of the directive on short-term capital movements.)

In the institutional field:

- 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.

In the economic field:

- complete removal of internal barriers and liberalisation of exchanges of goods, services and capital within the Community, according to the single market programme adopted in the Single Act; strengthening of Community competition policy and of the executive and judiciary authority to identify and sanction infringements of Community law;
- full implementation of the "Brussels package" of 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 budgetary policy co-ordination. The thrust of the revision of the 1974 convergence decision will be to strengthen considerably the possibilities for an assessment and ~~a better~~ implementation of the overall policy mix in the Community. 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 will:

- set up a new procedure for budgetary policy co-ordination, with quantitative guidelines, where appropriate, and medium-term orientations;
- 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;
- contain a ~~commitment by all~~ programme for concerned member countries 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].

In the monetary field:

- capital transactions: the coming into force of the June 1988 directive liberalising monetary movements in July 1990 will establish a regime of complete freedom of capital transactions. During this first stage a directive would be adopted to harmonise tax treatment of capital revenues to the extent that is necessary to avoid distortions in capital flows;
- EMS and policy co-ordination: following the procedure used in 1978 for the creation of the EMS (a Resolution of the European Council followed by an agreement between central banks) a reform of EMS arrangements would be implemented along the following lines:

  - creation of a European Reserve Fund, the ERF, [replacing EMCF when all EMS countries are participants] with the task of intervening in third currencies and eventually in Community currencies intramarginally or at the limit in order to supplement

individual action when tensions appear. The ERF's intervention should take place after unanimous agreement has been reached between central bank members. Interventions would serve the two purposes of creating a "training ground" and providing a signal effect through concerted interventions;

- the resources of the ERF will be provided by a pooling of reserves of the participating central banks that would represent initially 10% of their gold holding and 10% of their foreign currency holdings;
- the ERF would ensure the management of these reserves;
- the ERF would also set up a Monetary Policy Department which would be in charge of analysing in particular interest rate trends, monetary aggregates and domestic demand. It would thereby facilitate from a Community point of view the concerted management of exchange rates and the co-ordination of monetary policies among the different participating central banks;
- this phase could go along with the creation of a monetary policy co-ordination committee, which would define common surveillance instruments, propose harmonised objectives, and would progressively graduate from an ex post analysis to an ex ante approach to monetary policy adjustment;
- all the EEC's central banks would be eligible to join the ERF. However, membership would be subject to their participation in the exchange rate mechanism and the pooling of a portion of their reserves;
- as a forerunner of the future European Central Bank or the European system of central banks, 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;

- two committees: a Foreign Exchange Policy and a Monetary Policy Committee. They would report regularly to the Committee of Governors and, in the framework of a more active "monitoring", would recommend appropriate action in the field of exchange rates and interest rates;
- two departments: a Foreign Exchange and Reserves Management Department, and a Monetary Policy Department.

- bank supervision: regular consultations concerning matters of common interest in the field of banking supervision are within [the European Reserve Fund? the Committee of Governors]

- ECU developments: removal of regulatory impediments that may prevent market participants using the ECU in setting prices, keeping corporate accounts, and contracting any kind of pecuniary obligations. The ECU remains a basket.

B(2) Stage two

(to be enacted when the new Treaty comes into force.)

In the economic field:

- the Centre for economic policy decisions (CEPD) would start operating with a view to promoting convergence and co-ordination of economic policy in the Community. [Following the programme set out in the new Treaty, legislative and executive measures would be taken, at the Community as well as the national level, leading to the creation of a European Fiscal Framework (EFF). Such a system would cover: essential tax harmonisation; the respective roles of national and Community budgets; "own" resources of the Community budget; the size of budget deficits and their financing;]

- [in accordance with the programme for the EFF,] this stage would include:

  - introduction of 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.

In the monetary field:

- creation of the European system of central banks (ESCB) described in Part II of this Report, with its ~~central body (the Federal European Monetary Institution - FEMI)~~, decision-making organs (Board and Council), balance sheet, and legal underpinnings: mandate to preserve price stability, independence, accountability, decision-making procedures. The ESCB would replace the pre-existing institutional monetary arrangements (EMCF, ERF, Committee of Governors). The ~~FEMI~~ ESCB would take over the claims and liabilities of the ERF, assume its functions and incorporate its institutional features. In addition to the tasks that had already been entrusted to the ERF in the preceding stage, the ~~FEMI~~ ESCB would:

  - act as a forum for [binding] ex ante co-ordination of national monetary policies, with the execution of these policies being left to national central banks. The co-ordination would take place in the ~~FEMI~~ ESCB Council

- to impose constraints on national budgets when 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 make discretionary changes (through a procedure to be defined) in the level of harmonised taxation rates;
- to apply some form of conditionality to existing Community budgetary transfers and to Community loans (as a substitute for the present medium-term loans facility).

In the monetary field:

- ~~the beginning of this stage would be marked by the~~ announcement of irrevocable fixing of parities between the Community currencies;
- concurrently the full responsibility for the formulation of monetary policy in the Community would be attributed to the ~~EMI~~ ESCB Council, replacing the [binding] ex ante co-ordination procedure followed during the preceding stage;
- decisions on exchange market interventions in third currencies would be made entirely under the responsibility of the ~~EMI~~ ESCB Council; the execution of interventions would be entrusted to [one or ?] national central banks;
- the implementation of the Community's monetary policy would be carried out by the Board of ~~the EMI~~ in co-operation with national central banks. In order to be able to influence overall monetary developments in accordance with the decisions of ~~the~~ ~~EMI~~ ESCB Council, the ~~EMI~~ ESCB would be empowered both to impose and vary minimum reserves [in ECU; national currencies, third currencies?] to be held by national central banks and to operate directly in the money markets.

B(4) Last stage: the ECU replaces national currencies.