COMMITTEE FOR THE STUDY OF
ECONOMIC AND MONETARY UNION

12th April 1989

REPORT ON

ECONOMIC AND MONETARY

UNION IN THE EUROPEAN COMMUNITY

This report has been prepared in response to the mandate of the European Council "to study and propose concrete stages leading towards economic and monetary union".

Foreword

At its meeting in Hanover on 27th-28th June 1988 the European Council recalled that, "in adopting the Single Act, the Member States of the Community confirmed the objective of progressive realisation of economic and monetary union". The Heads of State and Government therefore decided to examine at the European Council meeting in Madrid in June 1989 the means of achieving this union. To that end they decided to entrust to a Committee, chaired by Mr. Jacques Delors, President of the European Commission, "the task of studying and proposing concrete stages leading towards this union".

In response to this request, the Committee has the honour to submit the attached Report. The ideas expressed and the proposals contained in the Report are put forward by the members of the Committee in their personal capacity. A collection of papers submitted to the Committee will be published.

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I. Past and present developments in economic and monetary integration in the Community

1. The objective of economic and monetary union

1. In 1969 the Heads of State and Government, meeting in The Hague, agreed that a plan should be drawn up with a view to the creation, in stages, of an economic and monetary union within the Community. This initiative was taken against the background of major achievements by the Community in the 1960s: the early completion of the transition period leading to a full customs union, the establishment of the common agricultural policy and the creation of a system of own resources. At the same time the Bretton Woods system was showing signs of decline. The Werner Report, prepared in 1970, presented a plan for the attainment of economic and monetary union. In March 1971, following the Werner Report, member states expressed "their political will to establish an economic and monetary union".

2. Several important moves followed: in 1972 the "snake" was created; in 1973 the European Monetary Co-operation Fund (EMCF) was set up; and in 1974 the Council Decision on the attainment of a high degree of convergence in the Community and the Directive on stability, growth and full employment were adopted. Yet, by the mid-1970s the process of integration had lost momentum under the pressure of divergent policy responses to the economic shocks of the period.

3. In 1979 the process of monetary integration was relaunched with the creation of the European Monetary System (EMS) and the European Currency Unit (ECU). The success of the EMS in promoting its objectives of internal and external monetary stability has contributed in recent years to further progress, as reflected in the adoption, in 1985, of the internal market programme and the signing of the Single European Act.

2. The European Monetary System and the ECU

4. The European Monetary System was created by a Resolution of the European Council followed by a Decision of the Council of Ministers and an Agreement between the participating central banks.

5. Within the framework of the EMS the participants in the exchange rate mechanism have succeeded in creating a zone of increasing monetary stability at the same time as gradually relaxing capital controls. The exchange rate constraint has greatly helped those participating countries with relatively high rates of inflation in gearing their policies, notably monetary policy, to the objective of price stability, thereby laying the foundations for both a downward convergence of inflation rates and the attainment of a high degree of exchange rate stability. This, in turn, has helped moderate cost increases in many countries, and has led to an improvement in overall economic performance. Moreover, reduced uncertainty regarding exchange rate developments and the fact that the parities of the participating currencies have not been allowed to depart significantly from what is appropriate in the light of economic fundamentals have protected intra-European trade from excessive exchange rate volatility.

The EMS has served as the focal point for improved monetary policy co-ordination and has provided a basis for multilateral surveillance within the Community. In part, its success can be attributed to the participants' willingness to opt for a strong currency stance. Also important has been the flexible and pragmatic way in which the System has been managed, with increasingly close co-operation among central banks. Moreover, the System has benefited from the role played by the Deutsche Mark as an "anchor" for participants' monetary and intervention policies. The EMS has evolved in response to changes in the economic and financial environment, and on two occasions (Palermo 1985 and Basle/Nyborg 1987) its mechanisms have been extended and strengthened.

At the same time, the EMS has not fulfilled its full potential. Firstly, a number of Community countries have not yet joined the exchange rate mechanism and one country participates with wider fluctuation margins. Secondly, the lack of sufficient convergence of fiscal policies as reflected in large and persistent budget deficits in certain countries has remained a source of tensions and has put a disproportionate burden on

monetary policy. Thirdly, the transition to the second stage of the EMS and the establishment of the European Monetary Fund, as foreseen by the Resolution of the European Council adopted in 1978, have not been accomplished.

6. In launching the EMS, the European Council declared in 1978 that "a European Currency Unit (ECU) will be at the centre of the EMS". Apart from being used as the numeraire of the exchange rate mechanism and to denominate operations in both the intervention and credit mechanisms, the ECU serves primarily as a reserve asset and a means of settlement for EMS central banks. Although it is an integral part of the EMS, the ECU has for a number of reasons played only a limited role in the operating mechanisms of the EMS. One reason is that central banks have preferred to intervene intra-marginally; therefore, compulsory interventions and the build-up of intervention balances to be settled in ECUs have remained rather limited.

By contrast, the ECU has gained considerable popularity in the market place, where its use as a denominator for financial transactions has spread significantly. It ranks fifth in international bond issues, with a 6% market share. The expansion of financial market activity in ECUs reflects in part a growing issuance of ECU-denominated debt instruments by

the broad support of consumers and producers and that their economic decisions are increasingly influenced by the prospects of 1992. The anticipation of a market without internal frontiers has generated a new dynamism and has contributed to the recent acceleration of economic growth in the Community.

4. Problems and perspectives

10. The completion of the single market will link national economies much more closely together and significantly increase the degree of economic integration within the Community. It will also entail profound structural changes in the economies of the member countries. These changes offer considerable opportunities for economic advancement, but many of the potential gains can only materialise if economic policy - at both national and Community levels - responds adequately to the structural changes.

By greatly strengthening economic interdependence between member countries, the single market will reduce the room for independent policy manoeuvre and amplify the cross-border effects of developments originating in each member country. It will, therefore, necessitate a more effective co-ordination of policy between separate national authorities. Furthermore, Community policies in support of a broadly balanced development are an indispensable complement to a single market. Indeed, the need to back up the removal of market barriers with a strengthening of common regional and structural policies was clearly recognised in the Brussels package of measures agreed in February 1988.

11. Although substantial progress has been made, the process of integration has been uneven. Greater convergence of economic performance is needed. Despite a marked downward trend in the average rate of price and wage inflation, considerable national differences remain. There are also still notable divergences in budgetary positions and external imbalances have become markedly greater in the recent past. The existence of these

significant increase in economic welfare in the Community. Indeed, economic and monetary union implies far more than the single market programme and, as is discussed in the following two Parts of this Report, will require further major steps in all areas of economic policy-making. A particular role would have to be assigned to common policies aimed at developing a more balanced economic structure throughout the Community. This would help to prevent the emergence or aggravation of regional and sectoral imbalances which could threaten the viability of an economic and monetary union. This is especially important because the adoption of permanently fixed exchange rates would eliminate an important indicator of policy inconsistencies among Community countries and remove the exchange rate as an instrument of adjustment from the member countries' set of economic tools. Economic imbalances among member countries would have to be corrected by policies affecting the structure of their economies and costs of production if major regional disparities in output and employment were to be avoided.

15. At its meeting on 27th-28th June 1988, the European Council confirmed the objective of economic and monetary union for the Community. In accordance with its mandate, the Committee has focused its attention on the task of studying and proposing concrete stages leading towards the

how to achieve economic and monetary union the Committee has examined the conditions under which such a union could be viable and successful. The Committee feels that concrete proposals towards attaining this objective can only be made if there is a clear understanding of the implications and requirements of economic and monetary union and if due account is taken of past experience with and developments in economic and monetary integration in the Community. Hence, Part II of this Report examines the principal features and implications of an economic and monetary union. Part III then presents a pragmatic step-by-step approach which could lead in three stages to the final objective. The question of when these stages should be implemented is a matter for political decision.

2. The principal features of monetary union

22. A monetary union constitutes a currency area in which policies are managed jointly with a view to attaining common macro-economic objectives. As already stated in the 1970 Werner Report, there are three necessary conditions for a monetary union:

- the assurance of total and irreversible convertibility of currencies;
- the complete liberalisation of capital transactions and full integration of banking and other financial markets; and
- the elimination of margins of fluctuation and the irrevocable locking of exchange rate parities.

The first two of these requirements have already been met, or will be with the completion of the internal market programme. The single most important condition for a monetary union would, however, be fulfilled only when the decisive step was taken to lock exchange rates irrevocably.

As a result of this step, national currencies would become increasingly close substitutes and their interest rates would tend to converge. The pace with which these developments took place would depend critically on the extent to which firms, households, labour unions and other economic agents were convinced that the decision to lock exchange rates would not be reversed. Both coherent monetary management and convincing evidence of an effective co-ordination of non-monetary policies would be crucial.

23. The three above-mentioned requirements define a single currency area, but their fulfilment would not necessarily mark the end of the process of monetary unification in the Community. The adoption of a single currency, while not strictly necessary for the creation of a monetary union, might be seen - for economic as well as psychological and political reasons - as a natural and desirable further development of the monetary union. A single currency would clearly demonstrate the irreversibility of the move to monetary union, considerably facilitate the monetary management of the Community and avoid the transactions costs of converting currencies. A single currency, provided that its stability is ensured, would also have

a much greater weight relative to other major currencies than any individual Community currency. The replacement of national currencies by a single currency should therefore take place as soon as possible after the locking of parities.

24. The establishment of a monetary union would have far-reaching implications for the formulation and execution of monetary policy in the Community. Once permanently fixed exchange rates had been adopted, there would be a need for a common monetary policy, which would be carried out through new operating procedures. The co-ordination of as many national monetary policies as there were currencies participating in the union would not be sufficient. The responsibility for the single monetary policy would have to be vested in a new institution, in which centralised and collective decisions would be taken on the supply of money and credit as well as on other instruments of monetary policy, including interest rates.

This shift from national monetary policies to a single monetary policy is an inescapable consequence of monetary union and constitutes one of the principal institutional changes. Although a progressively intensified co-ordination of national monetary policies would in many respects have prepared the way for the move to a single monetary policy, the implications of such a move would be far-reaching. The permanent fixing of exchange rates would deprive individual countries of an important instrument for the correction of economic imbalances and for independent action in the pursuit of national objectives, especially price stability.

gain the experience that would be necessary to move to a single monetary policy.

3. The principal features of economic union

25. Economic union - in conjunction with a monetary union - combines the characteristics of an unrestricted common market with a set of rules which are indispensable to its proper working. In this sense economic union can be described in terms of four basic elements:

- the single market within which persons, goods, services and capital can move freely;
- competition policy and other measures aimed at strengthening market mechanisms;
- common policies aimed at structural change and regional development; and
- macro-economic policy co-ordination, including binding rules for budgetary policies.

In defining specific rules and arrangements governing an economic union, the Community should be guided by two considerations.

Firstly, the economic union should be based on the same market-oriented economic principles that underlie the economic order of its member countries. Differences in policy choices may exist between member countries or, within the same country, in different periods. However, beyond such differences, a distinctive common feature of economic systems in Europe is the combination of a large degree of freedom for market behaviour and private economic initiative with public intervention in the provision of certain social services and public goods.

Secondly, an appropriate balance between the economic and monetary components would have to be ensured for the union to be viable. This would be essential because of the close interactions between economic and monetary developments and policies. A coherent set of economic policies at the Community and national levels would be necessary to maintain permanently fixed exchange rates between Community currencies and, conversely, a common monetary policy, in support of a single currency area, would be necessary for the Community to develop into an economic union.

26. The creation of a single currency area would add to the potential benefits of an enlarged economic area because it would remove intra-Community exchange rate uncertainties and reduce transactions costs, eliminate exchange rate variability and reduce the susceptibility of the Community to external shocks.

At the same time, however, exchange rate adjustments would no longer be available as an instrument to correct economic imbalances within the Community. Such imbalances might arise because the process of adjustment and restructuring set in motion by the removal of physical, technical and fiscal barriers is unlikely to have an even impact on different regions or always produce satisfactory results within reasonable periods of time. Imbalances might also emanate from labour and other cost developments, external shocks with differing repercussions on individual economies, or divergent economic policies pursued at national level.

With parities irrevocably fixed, foreign exchange markets would cease to be a source of pressure for national policy corrections when national economic disequilibria developed and persisted. Moreover, the statistical measurement and the interpretation of economic imbalances might become more difficult because in a fully integrated market balance-of-payments figures, which are currently a highly visible and sensitive indicator of economic disequilibria, would no longer play such a significant role as a guidepost for policy-making. Nonetheless, such imbalances, if left uncorrected, would manifest themselves as regional disequilibria. Measures designed to strengthen the mobility of factors of production and the flexibility of prices would help to deal with such imbalances.

27. In order to create an economic and monetary union the single market would have to be complemented with action in three interrelated areas: competition policy and other measures aimed at strengthening market mechanisms; common policies to enhance the process of resource allocation in those economic sectors and geographical areas where the working of market forces needed to be reinforced or complemented; macro-economic co-ordination, including binding rules in the budgetary field; and other arrangements both to limit the scope for divergences between member countries and to design an overall economic policy framework for the Community as a whole.

28. Competition policy - conducted at the Community level - would have to operate in such a way that access to markets would not be impeded and market functioning not be distorted by the behaviour of private or public economic agents. Such policies would not only have to address conventional forms of restrictive practices and the abuse of dominant market positions, but would also have to deal with new aspects of antitrust laws, especially in the field of merger and takeover activities. The use of government subsidies to assist particular industries should be strictly circumscribed because they distort competition and cause an inefficient use and allocation of scarce economic resources.

29. Community policies in the regional and structural field would be necessary in order to promote an optimum allocation of resources and to spread welfare gains throughout the Community. If sufficient consideration were not given to regional imbalances, the economic union would be faced with grave economic and political risks. For this reason particular attention would have to be paid to an effective Community policy aimed at narrowing regional and structural disparities and promoting a balanced development throughout the Community. In this context the regional dimension of other Community policies would have to be taken into account.

Economic and monetary integration may have beneficial effects on the less developed regions of the Community. For example, regions with lower wage levels would have an opportunity to attract modern and rapidly growing service and manufacturing industries for which the choice of location would not necessarily be determined by transport costs, labour skills and market proximity. Historical experience suggests, however, that in the absence of countervailing policies, the overall impact on peripheral regions could be negative. Transport costs and economies of scale would tend to favour a shift in economic activity away from less developed regions, especially if they were at the periphery of the Community, to the highly developed areas at its centre. The economic and monetary union would have to encourage and guide structural adjustment which would help poorer regions to catch up with the wealthier ones.

A step in this direction was taken in February 1988 when the European Council decided to strengthen and reorganise the Community's regional and structural policies in several respects: the size of structural funds will be doubled over the period up to 1993, emphasis will

be shifted from project to programme financing, and a new form of partnership will be established between the Community and the recipient regions. Depending upon the speed of progress, such policies might have to be strengthened further after 1993 in the process of creating economic and monetary union.

At the same time, excessive reliance on financial assistance through regional and structural policies could cause tensions. The principal objective of regional policies should not be to subsidise incomes and simply offset inequalities in standards of living, but to help to equalise production conditions through investment programmes in such areas as physical infrastructure, communications, transportation and education so that large-scale movements of labour do not become the major adjustment factor. The success of these policies will hinge not only on the size of the available financial resources, but to a decisive extent also on their efficient use and on the private and social return on the investment programmes.

Apart from regional policies, the Treaty of Rome, as amended by the Single European Act, has established the basis for Community policies in areas such as infrastructure, research and technological development, and the environment. Such policies would not only enhance market efficiency and offset market imperfections, but could also contribute to regional development. While respecting the principle of subsidiarity, such policies would have to be developed further in the process towards economic and monetary union.

Wage flexibility and labour mobility are necessary to eliminate differences in competitiveness in different regions and countries of the Community. Otherwise there could be relatively large declines in output and employment in areas with lower productivity. In order to reduce adjustment burdens temporarily, it might be necessary in certain circumstances to provide financing flows through official channels. Such financial support would be additional to what might come from spontaneous capital flows or external borrowing and should be granted on terms and conditions that would prompt the recipient to intensify its adjustment efforts.

30. Macro-economic policy is the third area in which action would be necessary for a viable economic and monetary union. This would require an appropriate definition of the role of the Community in promoting price

stability and economic growth through the co-ordination of economic policies.

Many developments in macro-economic conditions would continue to be determined by factors and decisions operating at the national or local level. This would include not only wage negotiations and other economic decisions in the fields of production, savings and investment, but also the action of public authorities in the economic and social spheres. Apart from the system of binding rules governing the size and the financing of national budget deficits, decisions on the main components of public policy in such areas as internal and external security, justice, social security, education, and hence on the level and composition of government spending, as well as many revenue measures, would remain the preserve of member states even at the final stage of economic and monetary union.

However, an economic and monetary union could only operate on the basis of mutually consistent and sound behaviour by governments and other economic agents in all member countries. In particular, unco-ordinated and divergent national budgetary policies would undermine monetary stability and generate imbalances in the real and financial sectors of the Community. Moreover, the fact that the centrally managed Community budget is likely to remain a very small part of total public sector spending and that much of this budget will not be available for cyclical adjustments will mean that the task of setting a Community-wide fiscal policy stance will have to be performed through the co-ordination of national budgetary policies. Without such co-ordination it would be impossible for the Community as a whole to establish a fiscal/monetary policy mix appropriate for the preservation of internal balance, or for the Community to play its part in the international adjustment process. Monetary policy alone cannot be expected to perform these functions. Moreover, strong divergences in wage levels and developments, not justified by different trends in productivity, would produce economic tensions and pressures for monetary expansion.

To some extent market forces can exert a disciplinary influence. Financial markets, consumers and investors would respond to differences in macro-economic developments in individual countries and regions, assess their budgetary and financial positions, penalise deviations from commonly agreed budgetary guidelines or wage settlements, and thus exert pressure for sounder policies. However, experience suggests that market perceptions do not necessarily provide strong and compelling signals and that access to

a large capital market may for some time even facilitate the financing of economic imbalances. Rather than leading to a gradual adaptation of borrowing costs, market views about the creditworthiness of official borrowers tend to change abruptly and result in the closure of access to market financing. The constraints imposed by market forces might either be too slow and weak or too sudden and disruptive. Hence countries would have to accept that sharing a common market and a single currency area imposed policy constraints.

In the general macro-economic field, a common overall assessment of the short-term and medium-term economic developments in the Community would need to be agreed periodically and would constitute the framework for a better co-ordination of national economic policies. The Community would need to be in a position to monitor its overall economic situation, to assess the consistency of developments in individual countries with regard to common objectives and to formulate guidelines for policy.

As regards wage formation and industrial relations, the autonomous negotiating process would need to be preserved, but efforts would have to be made to convince European management and labour of the advantages of gearing wage policies largely to improvements in productivity. Governments, for their part, would refrain from direct intervention in the wage and price formation process.

In the budgetary field, binding rules are required that would: firstly, impose effective upper limits on budget deficits of individual member countries of the Community, although in setting these limits the situation of each member country might have to be taken into consideration; secondly, exclude access to direct central bank credit and other forms of monetary financing while, however, permitting open market operations in government securities; thirdly, limit recourse to external borrowing in non-Community currencies. Moreover, the arrangements in the budgetary field should enable the Community to conduct a coherent mix of fiscal and monetary policies.

4. Institutional arrangements

31. Management of the economic and monetary union would call for an institutional framework which would allow policy to be decided and executed at the Community level in those economic areas that were of direct

relevance for the functioning of the union. This framework would have to promote efficient economic management, properly embedded in the democratic process. Economic and monetary union would require the creation of a new monetary institution, placed in the constellation of Community institutions (European Parliament, European Council, Council of Ministers, Commission and Court of Justice). The formulation and implementation of common policies in non-monetary fields and the co-ordination of policies remaining within the competence of national authorities would not necessarily require a new institution; but a revision and, possibly, some restructuring of the existing Community bodies, including an appropriate delegation of authority, could be necessary.

32. A new monetary institution would be needed because a single monetary policy cannot result from independent decisions and actions by different central banks. Moreover, day-to-day monetary policy operations cannot respond quickly to changing market conditions unless they are decided centrally. Considering the political structure of the Community and the advantages of making existing central banks part of a new system, the domestic and international monetary policy-making of the Community should be organised in a federal form, in what might be called a European System of Central Banks (ESCB). This new System would have to be given the full status of an autonomous Community institution. It would operate in accordance with the provisions of the Treaty, and could consist of a central institution (with its own balance sheet) and the national central banks. At the final stage the ESCB - acting through its Council - would be responsible for formulating and implementing monetary policy as well as managing the Community's exchange rate policy vis-à-vis third currencies. The national central banks would be entrusted with the implementation of policies in conformity with guidelines established by the Council of the ESCB and in accordance with instructions from the central institution.

The European System of Central Banks would be based on the following principles:

Mandate and functions

- the System would be committed to the objective of price stability;

- subject to the foregoing, the System should support the general economic policy set at the Community level by the competent bodies;
- the System would be responsible for the formulation and implementation of monetary policy, exchange rate and reserve management, and the maintenance of a properly functioning payment system;
- the System would participate in the co-ordination of banking supervision policies of the supervisory authorities.

Policy instruments

- the policy instruments available to the System, together with a procedure for amending them, would be specified in its Statutes; the instruments would enable the System to conduct central banking operations in financial and foreign exchange markets as well as to exercise regulatory powers;
- while complying with the provision not to lend to public sector authorities, the System could buy and sell government securities on the market as a means of conducting monetary policy.

Structure and organisation

- a federative structure, since this would correspond best to the political diversity of the Community;
- establishment of an ESCB Council (composed of the Governors of the central banks and the members of the Board, the latter to be appointed by the European Council), which would be responsible for the formulation of and decisions on the thrust of monetary policy; modalities of voting procedures would have to be provided for in the Treaty;
- establishment of a Board (with supporting staff), which would monitor monetary developments and oversee the implementation of the common monetary policy;
- national central banks, which would execute operations in accordance with the decisions taken by the ESCB Council.

Status

- Independence: the ESCB Council should be independent of instructions from national governments and Community authorities; to that effect the members of the ESCB Council, both Governors and the Board members, should have appropriate security of tenure;
- Accountability: reporting would be in the form of submission of an annual report by the ESCB to the European Parliament and the European Council; moreover, the Chairman of the ESCB could be invited to report to these institutions. Supervision of the administration of the System would be carried out independently of the Community bodies, for example by a supervisory council or a committee of independent auditors.

33. In the economic field, in contrast to the monetary field, an institutional framework for performing policy tasks was already established under the Treaty of Rome, with different and complementary functions conferred on the European Parliament, the Council of Ministers, the Monetary Committee, the Commission and the Court of Justice. The new Treaty would therefore not have to determine the mandate, status and structure of a new institution but would have to provide for additional or changed roles for the existing bodies in the light of the policy functions they would have to fulfil in an economic and monetary union. It would have to specifically define these changes and determine the areas in which decision-making authority would have to be transferred from the national to the Community level.

General criteria

In order to ensure the flexible and effective conduct of policies in those economic areas in which the Community would be involved, several basic requirements would have to be fulfilled:

- where policies were decided and enacted at the Community level, there would have to be a clear distribution of responsibilities among the existing Community institutions, a distinction being made as to whether decisions related to the setting of broad

policy directions or to day-to-day operations. By analogy with the structure of the European System of Central Banks, where the ESCB Council would determine the broad lines of monetary policy and the Board would be responsible for its day-to-day execution, a similar division of responsibilities could be envisaged in the economic field. The Council of Ministers would determine the broad lines of economic policy, while the implementation would be left to the national governments and the Commission in their respective areas of competence;

- in the event of non-compliance by member states, the Commission, or another appropriately delegated authority as envisaged in paragraph 31, would be responsible for taking effective action to ensure compliance; the nature of such action would have to be explored.

Single market and competition policy

In these two areas, the necessary procedures and arrangements have already been established by the Treaty of Rome and the Single European Act, which confer the requisite legislative, executive and judicial authority on the Community. The completion of the internal market will result in a marked easing of the overall burden of regulation for economic agents, but for the Community institutions it will mean a substantial addition to their executive and policing functions.

Community policies in the regional and structural field

The foundations for a more effective Community role in regional and structural development have recently been established, with both a doubling of the resources of structural funds and a reorganisation of policies as described earlier in this Report. These mechanisms would perhaps have to be further extended and made more effective as part of the process leading to economic and monetary union.

Macro-economic policy

The broad objective of economic policy co-ordination would be to promote growth, employment and external balance in an environment of price stability and economic cohesion. For this purpose co-ordination would involve defining a medium-term framework for budgetary policy within the

economic and monetary union; managing common policies with a view to structural and regional development; formulating in co-operation with the ESCB Council the Community's exchange rate policy; and participating in policy co-ordination at the international level.

New procedures required for this purpose would have to strike a balance between reliance on binding rules, where necessary, to ensure effective implementation and discretionary co-ordination adapted to particular situations.

In particular it would seem necessary to develop both binding rules and procedures for budgetary policy, involving respectively:

- effective upper limits on budget deficits of individual member countries; exclusion of access to direct central bank credit and other forms of monetary financing; limits on borrowing in non-Community currencies;
- the definition of the overall stance of fiscal policy over the medium term, including the size and financing of the aggregate budgetary balance, comprising both the national and the Community positions.

34. The new Treaty laying down the objectives, features, requirements, procedures and organs of the economic and monetary union would add to the existing Community institutions (European Parliament, European Council, Council of Ministers, Commission and Court of Justice) a new institution of comparable status, the European System of Central Banks. With due respect for the independent status of the ESCB, as defined elsewhere in this Report, appropriate consultation procedures would have to be set up to allow for effective co-ordination between budgetary and monetary policy. This might involve attendance by the President of the Council and the President of the Commission at meetings of the ESCB Council, without power to vote or to block decisions taken in accordance with the rules laid down by the ESCB Council. Equally, the Chairman of the ESCB Council might attend meetings of the Council of Ministers, especially on matters of relevance to the conduct of monetary policy. Consideration would also have to be given to the role of the European Parliament, especially in relation to the new policy functions exercised by various Community bodies.

5. Economic and monetary union in the context of the world economy

35. The establishment of an economic and monetary union would give the Community a greater say in international negotiations and enhance its capacity to influence economic relations between industrial and developing countries.

36. The responsibility for external trade policy has been assigned to the Community in the Treaty of Rome, and the Commission, acting as the Community's spokesman, represents all the member countries in multilateral trade negotiations. This role will be strengthened with the completion of the single market, which has the potential to stimulate multilateral trade and economic growth at the global level. However, this potential can only be exploited to the full in an open trading system, which guarantees foreign suppliers free access to the Community market and, conversely, guarantees exporters from the Community free access to foreign markets. The removal of internal trade barriers within the Community should constitute a step towards a more liberal trading system on a worldwide scale.

37. The creation of an economic and monetary union would increase the role of the Community in the process of international policy concertation. In the monetary field this would involve short-term co-operation between central banks in interest rate management and exchange market interventions as well as the search for solutions to issues relating to the international monetary system. In the economic field, the formulation of a policy mix would allow the Community to contribute more effectively to world economic management.

38. The institutional arrangements which would enable the Community to fulfil the new responsibilities implied by its increased weight in the world economy are partly in place or would be implemented in the process of creating an economic and monetary union. In the area of external trade policies and, to some extent, in the field of co-operation with developing countries, the responsibilities have already been attributed to the Community. With the establishment of the European System of Central Banks the Community would also have created an institution through which it could participate in all aspects of international monetary management. As far as

macro-economic policy co-ordination at the international level is concerned, the Community as such is currently represented only at the summit meetings of the major industrial countries. In order to make full use of its position in the world economy and to exert influence on the functioning of the international economic system, the Community would have to be able to speak with one voice. This emphasises the need for an effective mechanism for macro-economic policy co-ordination within the economic and monetary union.

III. Steps towards economic and monetary union

39. After defining the main features of an economic and monetary union, the Committee has undertaken the "task of studying and proposing concrete stages leading towards this union". The Committee agreed that the creation of an economic and monetary union must be viewed as a single process. Although this process is set out in stages which guide the progressive movement to the final objective, the decision to enter upon the first stage should be a decision to embark on the entire process.

A clear political commitment to the final stage, as described in Part II of this Report, would lend credibility to the intention that the measures which constitute stage one should represent not just a useful end in themselves but a firm first step on the road towards economic and monetary union. It would be a strong expression of such a commitment if all members of the Community became full members of the EMS in the course of stage one and undertook the obligation to formulate a convergent economic policy within the existing institutions.

Given that background, commitment by the political authorities to enter into negotiations on a new Treaty would ensure the continuity of the process. Preparatory work for these negotiations would start immediately. At the end of this Report suggestions are made regarding the procedures to be followed for the further development of economic and monetary union.

1. Principles governing a step-by-step approach

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

41. Discrete but evolutionary steps. The process of implementing economic and monetary union would have to be divided into a limited number of clearly defined stages. Each stage would have to represent a significant change with respect to the preceding one. New arrangements coming into force at the beginning of each stage would gradually develop their effects and bring about a change in economic circumstances so as to pave the way for the next stage. This evolutionary development would apply to both functional and institutional arrangements.

42. Parallelism. As has been argued in Part II, monetary union without a sufficient degree of convergence of economic policies is unlikely to be durable and could be damaging to the Community. Parallel advancement in economic and monetary integration would be indispensable in order to avoid imbalances which could cause economic strains and loss of political support for developing the Community further into an economic and monetary union. Perfect parallelism at each and every point of time would be impossible and could even be counter-productive. Already in the past the advancement of the Community in certain areas has taken place with temporary standstill in others, so that parallelism has been only partial. Some temporary deviations from parallelism are part of the dynamic process of the Community. But bearing in mind the need to achieve a substantial degree of economic union if monetary union is to be successful, and given the degree of monetary co-ordination already achieved, it is clear that material progress on the economic policy front would be necessary for further progress on the monetary policy front. Parallelism would have to be maintained in the medium term and also before proceeding from one stage to the next.

43. Calendar. The conditions for moving from stage to stage cannot be defined precisely in advance; nor is it possible to foresee today when

52. In the monetary field the focus would be on removing all obstacles to financial integration and on intensifying co-operation and the co-ordination of monetary policies. In this connection consideration should be given to extending the scope of central banks' autonomy. Realignments of exchange rates would still be possible, but an effort would be made by every country to make the functioning of other adjustment mechanisms more effective. Action would be taken along several lines.

Firstly, through the approval and enforcement of the necessary Community Directives, the objective of a single financial area in which all monetary and financial instruments circulate freely and banking, securities and insurance services are offered uniformly throughout the area would be fully implemented.

Secondly, it would be important to include all Community currencies in the EMS exchange rate mechanism. The same rules would apply to all the participants in the exchange rate mechanism.

Thirdly, all impediments to the private use of the ECU would be removed.

Fourthly, the 1964 Council Decision defining the mandate of the Committee of Central Bank Governors would be replaced by a new Decision. According to this decision the Committee of Central Bank Governors should:

- formulate opinions 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 normally be consulted in advance of national decisions on the course of monetary policy, such as the setting of annual domestic monetary and credit targets;
- express opinions to individual governments and the Council of Ministers on 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 by the Chairman of the Committee;
- submit an annual report on its activities and on the monetary situation of the Community to the European Parliament and the European Council.

The Committee could express majority opinions, although at this stage they would not be binding. In order to make its policy co-ordination function more effective, the Committee would set up three sub-committees, with a greater research and advisory role than those existing hitherto, and provide them with a permanent research staff:

- a monetary policy committee would define common surveillance indicators, propose harmonised objectives and instruments and help to gradually bring about a change from ex post analysis to an ex ante approach to monetary policy co-operation;
- a foreign exchange policy committee would monitor and analyse exchange market developments and assist in the search for effective intervention strategies;
- an advisory committee would hold regular consultations on matters of common interest in the field of banking supervision policy.

53. A number of Committee members advocated the creation of a European Reserve Fund (ERF) that would foreshadow the future European System of Central Banks. The main objectives of the ERF 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 possibly to intervene visibly (in third and participating currencies) on the foreign exchange market at the request of the participating central banks;
- to be the symbol of the political will of the European countries and thus reinforce the credibility of the process towards economic and monetary union.

The resources of the Fund would be provided by the pooling of a limited amount of reserves (for instance 10% at the start) by participating central banks. The Fund would, moreover, require a permanent structure and staff in order to carry out its tasks, viz.:

- managing the pooled reserves;
- intervening on the exchange markets as decided by the members;

- analysing monetary trends, from a collective perspective, 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, both of which require a common approach on the part of the central banks concerned.

The ERF would consist of:

- a Board of Directors, which would comprise, ex officio, the Governors of all the central banks 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 small in size, consisting of three or four members who would have direct responsibility for the different departments of the ERF;
- the three Committees, namely the Foreign Exchange Policy Committee, the Monetary Policy Committee and the Committee on Banking Supervision Policy;
- two departments: a Foreign Exchange and Reserve Management Department and a Monetary Policy Department.

54. Other members of the Committee felt that the creation of an ERF was not opportune at this stage. Their reservations stem from the following considerations:

- too much emphasis is placed on external considerations; common interventions by such a Fund cannot be a substitute for economic adjustment to correct imbalances within the Community;
- the proposal involves an institutional change which, in accordance with Article 102A of the amended Treaty of Rome, would fall under the procedure stipulated in Article 236 and require a new Treaty; the setting-up of a Fund under the same procedures as those applied in establishing the EMS is not considered possible;

- they consider that some functions of the Fund could be performed by the Committee of Governors if it were given wider powers; thus there is no need to set up a new institution immediately;
- what, in the view of these members, is essential is co-ordination of intervention policies rather than the technique of common interventions. Such co-ordination can provide the necessary training ground while avoiding the unnecessary complication of instituting an additional intervention window.

4. The principal steps in stage two

55. The second stage could begin only when the new Treaty had come into force. In this stage the basic organs and structure of the economic and monetary union would be set up, 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 analysing macro-economic developments and promote a process of common decision-making, with certain operational decisions taken by majority vote. Stage two must be seen as a period of transition to the final stage and would thus primarily constitute a training process leading to collective decision-making, while the ultimate responsibility for policy decisions would remain at this stage with national authorities. The precise operating procedures to be applied in stage two would be developed in the light of the prevailing economic conditions and the experience gained in the previous stage.

56. In the economic field, the European Parliament, the Council of Ministers, the Monetary Committee and the Commission would reinforce their action along three lines.

Firstly, in the area of the single market and competition policy the results achieved through the implementation of the single market programme would be reviewed and, wherever necessary, consolidated.

Secondly, the performance of structural and regional policies would be evaluated and, if necessary, be adapted in the light of experience. The resources for supporting the structural policies of the member states might have to be enlarged. Community programmes for investment in research and infrastructure would be strengthened.

Thirdly, in the area of macro-economic policy, the procedures set up in the first stage through the revision of the 1974 Decision on convergence would be further strengthened and extended on the basis of the new Treaty. Policy guidelines would be adopted by majority decision. On this basis the Community would:

- set a medium-term framework for key economic objectives aimed at achieving stable growth, with a follow-up procedure for monitoring performances and intervening when significant deviations occurred;
- set precise - although not yet binding - rules relating to the size of annual budget deficits and their financing; the Commission should be responsible for bringing any instance of non-compliance by member states to the Council's attention and should propose action as necessary;
- assume a more active role as a single entity in the discussion of questions arising in the economic and exchange rate field, on the basis of its present representation (through the member states or the Commission) in the various fora for international policy co-ordination.

57. In the monetary field, the most important feature of this stage would be that the European System of Central Banks would be set up and would absorb the previously existing institutional monetary arrangements (the EMCF, the Committee of Central Bank Governors, the sub-committees for monetary policy analysis, foreign exchange policy and banking supervision, and the permanent secretariat). The functions of the ESCB in the formulation and operation of a common monetary policy would gradually evolve as experience was gained. Some possible schemes for co-ordinating monetary policies in the course of this stage are discussed in the Collection of papers submitted to the Committee. Exchange rate realignments would not be excluded as an instrument of adjustment, but there would be an understanding that they would be made only in exceptional circumstances.

The key task for the European System of Central Banks during this stage would be to begin the transition from the co-ordination of independent national monetary policies by the Committee of Central Bank Governors in stage one to the formulation and implementation of a common

monetary policy by the ESCB itself scheduled to take place in the final stage.

The fundamental difficulty inherent in this transition would lie in the organisation of a gradual transfer of decision-making power from national authorities to a Community institution. At this juncture, the Committee does not consider it possible to propose a detailed blueprint for accomplishing this transition, as this would depend on the effectiveness of the policy co-ordination achieved during the first stage, on the provisions of the Treaty, and on decisions to be taken by the new institutions. Account would also have to be taken of the continued impact of financial innovation on monetary control techniques (which are at present undergoing radical changes in most industrial countries), of the degree of integration reached in European financial markets, of the constellation of financial and banking centres in Europe and of the development of the private, and in particular banking, use of the ECU.

The transition that characterises this second stage would involve a certain number of actions. For instance, general monetary orientations would be set for the Community as a whole, with an understanding that national monetary policy would be executed in accordance with these global guidelines. Moreover, while the ultimate responsibility for monetary policy decisions would remain with national authorities, the operational framework necessary for deciding and implementing a common monetary policy would be created and experimented with. Also, a certain amount of exchange reserves would be pooled and would be used to conduct exchange market interventions in accordance with guidelines established by the ESCB Council. Finally, regulatory functions would be exercised by the ESCB in the monetary and banking field in order to achieve a minimum harmonisation of provisions (such as reserve requirements or payment arrangements) necessary for the future conduct of a common monetary policy.

As circumstances permitted and in the light of progress made in the process of economic convergence, the margins of fluctuation within the exchange rate mechanism would be narrowed as a move towards the final stage of the monetary union, in which they would be reduced to zero.

5. The principal steps in stage three

58. The final stage would commence with the move to irrevocably locked exchange rates and the attribution to Community institutions of the full monetary and economic competences described in Part II of this Report. In the course of the final stage the national currencies would eventually be replaced by a single Community currency.

59. In the economic field, the transition to this final stage would be marked by three developments.

Firstly, there might need to be a further strengthening of Community structural and regional policies. Instruments and resources would be adapted to the needs of the economic and monetary union.

Secondly, the rules and procedures of the Community in the macro-economic and budgetary field would become binding. In particular, the Council of Ministers, in co-operation with the European Parliament, would have the authority to take directly enforceable decisions, i.e.:

- to impose constraints on national budgets to the extent to which this was necessary to prevent imbalances that might threaten monetary stability;
- to make discretionary changes in Community resources (through a procedure to be defined) to supplement structural transfers to member states or to influence the overall policy stance in the Community;
- to apply to existing Community structural policies and to Community loans (as a substitute for the present medium-term financial assistance facility) terms and conditions that would prompt member countries to intensify their adjustment efforts.

Thirdly, the Community would assume its full role in the process of international policy co-operation, and a new form of representation in arrangements for international policy co-ordination and in international monetary negotiations would be adopted.

60. In the monetary field, the irrevocable locking of exchange rates would come into effect and the transition to a single monetary policy would

be made, with the ESCB assuming all its responsibilities as foreseen in the Treaty and described in Part II of this Report. In particular:

- concurrently with the announcement of the irrevocable fixing of parities between the Community currencies, the responsibility for the formulation and implementation of monetary policy in the Community would be transferred to the ESCB, with its Council and Board exercising their statutory functions;
- decisions on exchange market interventions in third currencies would be made on the sole responsibility of the ESCB Council in accordance with Community exchange rate policy; the execution of interventions would be entrusted either to national central banks or to the European System of Central Banks;
- official reserves would be pooled and managed by the ESCB;
- preparations of a technical or regulatory nature would be made for the transition to a single Community currency.

The change-over to the single currency would take place during this stage.

6. One or several Treaties

61. Legal basis. The Committee has examined the scope for progress in economic and monetary integration under the present legal provisions in force in each member country. This investigation has shown that under present national legislations no member country is able to transfer decision-making power to a Community body, nor is it possible for many countries to participate in arrangements for a binding ex ante co-ordination of policies.

As has been pointed out in paragraph 18 of this Report, the Treaty of Rome, as amended by the Single European Act, is insufficient for the full realisation of economic and monetary union. There is at present no transfer of responsibility for economic and monetary policy from member states to the Community. The rules governing the EMS are based on agreements between the central banks concerned and are not an integral part of Community legislation. Without a new Treaty it would not be possible to take major additional steps towards economic and monetary union. The

process of integration based on a step-by-step approach requires, however, a clear understanding of its content and final objective, its basic functional and institutional arrangements and the provisions governing its gradual implementation. A new political and legal basis would accordingly be needed. A new Treaty would establish not only the objective but also the stages by which it is to be achieved and the procedures and institutions required to move forward at each stage along the way. Political agreement would be required for each move to be implemented.

A new Treaty would also be required to ensure parallel progress in the economic and in the monetary fields. The appropriate institutional and procedural arrangements to that effect should also be set out in the Treaty.

62. The Committee has not investigated in detail the possible approaches by means of which the objective of economic and monetary union and its implementation would be embodied in the new Treaty. There would be basically two options. One procedure would be to conclude a new Treaty for each stage. The advantage of this procedure would be that it would explicitly reaffirm the political consensus at each stage and would allow for modification of the form the following stage should take in the light of experience with the current stage. At the same time, this approach might prove unwieldy and slow, it might not safeguard the overall consistency of the process sufficiently and it might carry the risk that parallel progress on the monetary and non-monetary sides might not be respected. In any event, if this procedure were chosen it would be crucial that the first Treaty laid down clearly the principal features of the ultimate objective of economic and monetary union.

63. Alternatively, it could be decided to conclude a single comprehensive Treaty formulating the essential features and institutional arrangements of economic and monetary union and the steps by which it could be achieved. Such a Treaty should indicate the procedures by which the decision would be taken to move from stage to stage. Each move would require an appraisal of the situation and a decision by the European Council.

7. Suggested follow-up procedure

64. If the European Council can accept this Report as a basis for further development towards economic and monetary union, the following procedure is suggested.

65. The Council and the Committee of Governors should be invited to take the decisions necessary to implement the first stage.

66. Preparatory work for the negotiations on the new Treaty would start immediately. The competent Community bodies should be invited to make concrete proposals on the basis of this Report concerning the second and the final stages, to be embodied in a revised Treaty. These proposals should contain a further elaboration and concretisation, where necessary, of the present Report. They should serve as the basis for future negotiations on a revised Treaty at an inter-governmental conference to be called by the European Council.

Annex I

Excerpts from the Conclusions of the Presidency presented after the meeting of the European Council in Hanover on 27th-28th June 1988

5. Monetary union

The European Council recalls that, in adopting the Single Act, the member states confirmed the objective of progressive realisation of economic and monetary union.

They therefore decided to examine at the European Council meeting in Madrid in June 1989 the means of achieving this union.

To that end they decided to entrust to a Committee the task of studying and proposing concrete stages leading towards this Union.

The Committee will be chaired by Mr. Jacques Delors, President of the European Commission.

The Heads of State and Government agreed to invite the President or Governor of their central banks to take part in a personal capacity in the proceedings of the Committee, which will also include one other member of the Commission and three personalities designated by common agreement by the Heads of State or Government. They have agreed to invite:

- Mr. Niels Thygesen, Professor of Economics, Copenhagen;
- Mr. Lamfalussy, General Manager of the Bank for International Settlements in Basle, Professor of Monetary Economics at the Catholic University of Louvain-la-Neuve;
- Mr. Miguel Boyer, President of "Banco Exterior de España".

The Committee should have completed its proceedings in good time to enable the Ministers for Economic Affairs and for Finance to examine its results before the European Council meeting in Madrid.

Annex II

List of members of the Committee

Jacques Delors (Chairman)
Frans Andriessen
Miguel Boyer
Demitrius J. Chalikias
Carlo Azeglio Ciampi
Maurice F. Doyle
Willem F. Duisenberg
Jean Godeaux
Erik Hoffmeyer
Pierre Jaans
Alexandre Lamfalussy
Jacques de Larosière
Robert Leigh-Pemberton
Karl Otto Pöhl
Mariano Rubio
José A.V. Tavares Moreira
Niels Thygesen

Rapporteurs:

Gunter D. Baer
Tommaso Padoa-Schioppa