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A Vice Directors General della Banca d'Italia

Rome, 18 August 1988

Dear Gunter, Jean Paul, Joly,

this is a draft of the "Issues Paper". It is written as an organic, concise and neutral basis for the discussions of the Committee in its meetings of, say, October and November. Later on the Committee might discuss more specifically the "concrete steps" and examine drafts of (parts of) the final Report. At this stage, however, the text should be problematic and not look like the outline of a report.

I have tried to follow closely the six groups of questions of Jacques Delors' attached interview with "Le Monde" (20 July 1988); the JD-TPS conversion key is roughly the following: 1-II, 2-IV, 3-III, 4-VI, 5-I, 6-V. I have done my best not to be biased in any sense. But if you find any imbalances, please make suggestion to correct them. Of the two key issues mentioned by Gunter, "balanced progress" is taken up in section VI, and "alternative routes" is treated explicitly in II.4 and implicitly elsewhere. Examples and factual references should be added and checked, as well as Annexes.

If the "Issues Paper" were to be sent to the Committee shortly after the September 13 meeting to give members enough time to get prepared for the long October meeting, a good portion of our August 31 meeting should be devoted to discussing it. Therefore I suggest that a draft should be sent to President Delors as soon as possible. Gunter could send it (via Bx1) after revision. Should the revision substantially modify this text, please add my original draft.

Best regards,

Tommaso
(T. Fadoa-Schioppa)

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Delegazione della Banca d'Italia
Rappresentanza dell'Ufficio Italiano dei Cambi - Parigi

PAG. 4

Les difficultés de l'union monétaire

- Le comité que vous présidez et qui a été chargé par le Conseil européen de Hanovre, le mois dernier, de réfléchir au programme à entreprendre pour parvenir à l'union monétaire vient de tenir sa première réunion. Quelles sont vos impressions ?

- Le comité tiendra sa première réunion formelle en septembre. En attendant, mon rôle de président est de prendre des contacts. Je viens de le faire avec les gouverneurs des banques centrales à Bâle. Je rencontrerai également les autres membres du comité ; ils sont tous à égalité ; ils ont tous été désignés à titre personnel.

- La difficulté du sujet a été généralement sous-estimée. Pour le montrer, il suffit que j'énumère les questions qui se posent :

① L'union économique et monétaire, objectif politique confirmé par l'acte unique, implique-t-elle une monnaie commune ? Dans l'affirmative, s'agira-t-il d'une monnaie parallèle aux monnaies nationales ou d'une monnaie unique ?

② Qui assurera la gestion de cette monnaie unique ? Un Fonds

monétaire européen, comme le prévoit le règlement instaurant le SME (système monétaire européen), ou une banque centrale européenne, comme le suggèrent certains ? Dans le second cas, quel sera le statut de cette banque centrale ? Sera-t-elle - comme la majorité des spécialistes le pensent - une banque à structure fédérale, ce qui entraînerait le maintien des instituts d'émission nationaux ? Quelles seront les missions de cette banque centrale et les moyens dont elle disposera pour les assumer ?

③ Si cette monnaie commune doit être l'ECU, quelle devrait être la définition de l'ECU ? Un panier de monnaies, comme jusqu'à présent, ou bien une monnaie dont le cours serait fixé par le marché sans lien avec une moyenne pondérée des monnaies nationales ? Comment, dès demain, renforcer l'attrait de l'ECU sur les plans économique, commercial et financier ?

④ Quelles transitions, quels pas concrets doivent nous amener au stade final ?

⑤ Quels sont les rapports entre l'union monétaire et l'union économique ? Autrement dit, quelles sont

les conditions macro-économiques qui permettront le succès de l'union économique et monétaire ? Quels seront les instruments des politiques communautaires qui devront être mis en place pour assurer la cohésion et la cohérence de notre ensemble économique ?

⑥ Comment devons-nous traduire en termes institutionnels cette innovation radicale que constituerait une monnaie commune et une banque centrale européenne ?

- Il y a donc beaucoup de travail à faire et un délai extrêmement bref, puisque le comité devra avoir terminé ses travaux pour le mois d'avril, afin que les ministres des finances puissent donner leur avis à leurs gouvernements respectifs. C'est la condition pour que la discussion puisse être fructueuse au conseil européen de Madrid, en juin 1989.

- Dans quel état d'esprit avez-vous trouvé les gouverneurs des banques centrales ?

- Ils sont conscients que chaque chef de gouvernement leur a fait confiance à titre personnel, et qu'ils ont à accomplir une des missions les

plus importantes qu'on puisse confier à des personnalités en vue de la construction européenne ; la monnaie est, en effet, avec la défense, un des sujets centraux dans la perspective de l'union politique de l'Europe.

- Vous avez dit que les difficultés avaient été sous-estimées. Par qui et à quel stade ?

- Je comprends que des personnalités extérieures aux instances de la Communauté lancent des idées. Je leur en suis d'ailleurs reconnaissant car, si on a parlé « monnaie » à Hanovre, c'est en raison de la pression qu'elles ont exercée, et aussi à cause de la décision prise par la Communauté sur la libération des mouvements de capitaux. Mais cette question ne relève pas uniquement de cette « volonté politique » que l'on se plaît à évoquer périodiquement, comme une sorte de potion magique, dans l'histoire de la construction européenne. Il y a un intense travail de réflexion à accomplir, le temps est court et, comme j'en ai l'habitude depuis que j'ai la charge de ces responsabilités, je me pose toujours deux questions : « Que faire ? » et « Comment le faire ? »

ECONOMIC AND MONETARY UNION: THE MAIN ISSUES

The purpose of this note is to present an organic but concise overview of the main questions and issues that the Committee is going to examine in fulfilling the mandate received from the European Council in Hannover.

Although an important part of future discussions will deal with the operational and institutional content of the "concrete steps" to approach the Economic and Monetary Union, this note is primarily focused on the Union itself. The reason is that intermediate steps could not be easily defined without a prior discussion of the end result of the entire process.

+ Hannover

I. ECONOMIC UNION

1. Definition
2. Policies to achieve the economic union
3. Fiscal policy aspects
4. Where do we stand?

II. MONETARY UNION

1. Objective
2. Monetary policy in the 1992 environment
3. Policy mix
4. Alternative models

III. THE CURRENCY OF THE UNION

1. A common currency?
2. The ECU

IV. THE MONETARY AUTHORITY

1. Mandate
2. Operations and Instruments
3. Organs and decision making
4. The monetary authority in alternative models of MU

V. LEGAL AND INSTITUTIONAL ISSUES

1. Non monetary aspects
2. Legal basis of a MU
3. Independence and accountability

VI. STEPWISE IMPLEMENTATION

1. Main phases
2. Moving from one phase to another

August 1988

will make it possible to resolve an area within which

↓ Member

I. ECONOMIC UNION

1. Definition. The Werner Report stated that in an Economic and Monetary Union (EMU) "goods and services, people and capital will circulate freely and without competitive distortions, without thereby giving rise to structural or regional disequilibrium".

- Is this definition still valid?
- Considering that some structural and regional disequilibria also exist within nations is the reference to disequilibrium too restrictive? What are the minimum requirements of an EMU in this respect?

2. Policies to achieve the Economic Union. The creation of an Economic Union is the result of an interplay of market forces and policy actions.

- What economic policies are necessary to create the conditions for an EMU as defined above?
- Removing all internal economic and physical barriers as stated in the 1992 programme (Annex A should give a 2 pp. summary of the programme) is a sufficient condition for the economic requirement of an EMU to be fulfilled?
- What wage, social and labour developments are necessary for an EMU to function? (Should specific Community guidelines be given to social partners for the negotiation of labour contracts?) Is a process of convergence to be expected as a result of the implementation of the internal market programme? Is this process to be considered favourably?

3. Fiscal Policy Aspects. The present situation can be characterized by the following elements:

- . the fiscal balances of member countries have somewhat converged but are still widely different; so are public debt to GDP ratios;
- . the fiscal policy coordination procedures set up in 1974 have proved ineffective;
- . the Community budget (... per cent of EC GDP) has no macroeconomic influence and a (significant? negligible? see TPS report, consult DG II) redistributive effect on less prosperous countries-regions.
- What degree of fiscal policy convergence is necessary in an EMU?
- To bring about the necessary convergence is it sufficient to rely on a) a "capital market constraint" and b) a "monetary policy constraint" deriving - as a working hypothesis - from the

discipline of a common monetary policy geared to price stability? If these two constraints were considered not sufficient, what form should take an additional, more direct, constraint on national budget policies? What would be the economic consequences of significant divergences in budget policies coexisting with the two constraints a and b above?

- In most fiscal systems the budget also performs a redistribution function (e.g. Finanzausgleich mechanism in the FRG): are the existing Community policies and instruments in this field quantitatively and qualitatively adequate (an Annex B should give a brief summary of them) for an EMU to be viable? What would be the consequences of proceeding towards a Monetary Union without further development of such budget functions? What qualitative and quantitative form should such development take?
4. Where do we stand? In the last 15 years the Community has evolved in many areas: economic, monetary, structural, regulatory, institutional, procedural, etc. (Annex C contains a summary of the main developments since the presentation of the Werner Report). Other changes are under way and will be completed by 1992.
- 2 - Could it be said a) that the procedures for fiscal policy consultations and cooperation have already gone beyond the Werner Report recommendations, but the degree of convergence in the area of budget policies falls short of the expectations and b) that the 1992 objectives in terms of internal market and financial integration (full capital mobility and liberalization of financial services) go further than the recommendations of the Werner Report?.

II. MONETARY UNION

1. Objective. In 1970, the Werner Report stated that a monetary union would imply "the total and irreversible convertibility of currencies, the elimination of margins of fluctuation in exchange rates, the irrevocable fixing of parity rates and the complete liberation of movements of capital". Since 1970 a long period of inflation in many countries has shown the narrow link between a stable currency and sustainable economic growth. It has also reestablished price stability as the first priority for monetary policy.

- What should be the objective of a Monetary Union? Is the Werner Report definition (based on two elements: irrevocably fixed parities and full mobility of capital) still valid? (What definition should be retained by the Committee?]

2 principal objectives

- 2 - How should monetary policy - not mentioned in the above definition - be considered in a valid concept of monetary union?]

2. Monetary policy in the 1992 environment. In the monetary and financial sphere the 1992 programme as stated in the Single European Act will be characterized a) by complete mobility of capital (including monetary instruments) and b) by complete freedom to provide banking and other financial services throughout the Community. Implementing this programme without changing the present arrangements in the field of monetary and exchange rate policies could have important consequences.

- What constraints will a) and b) de facto impose on the conduct of monetary policy by national authorities?
- What would be the consequences of member countries conducting divergent and incompatible monetary and interest rates policies?
- How would price stability be pursued and preserved?
- What are the consequences of a) and b) for the pursuing of monetary stability? Do they make it easier or more difficult? Do they imply changes in the way monetary policy is considered?

*4
2*

3. Policy mix. In nations with a federal structure (FRG, US, Canada, etc.: check!), in which there are one currency and one central bank, no formal constraint is in general imposed on the budgetary decisions of local Governments.

- Is there a "systemic" problem of fiscal, monetary policy mix to be solved in an EMU?
- If member States were to conduct divergent fiscal policies after a monetary union had been created, what would be the consequences for the conduct of monetary policy by the union?
- What safeguards would be required to make the conduct of monetary policy in a monetary union independent of pressure for "monetary expansion" that large public deficits and debts may generate?

3

4. Alternative Models. Many models and suggestions have been put forward in the debates of the last twenty years about a European Monetary Union. For the purpose of the Committee's work it would be useful to reduce them to a limited number of broad hypotheses, concerning the currency

macro-ec. policies at Community level

and the monetary authority of the Union. Sections III and IV below extend and develop questions about the currency and the authority respectively. Could the following four models be retained as a representative and useful categorization? The models are:

- i) centralized: one authority, one currency, replacing existing national central banks and currencies;
- ii) decentralized: no central authority or currency; fixed exchange rates; non binding policy coordination between national authorities;
- iii) competitive: in addition to the "decentralized" model there would be a parallel currency competing with (and perhaps eventually prevailing over) national currencies; to manage it a "central bank" for that currency would be set up at some point of the process;
- iv) federal: existing central banks and currencies would be federated into a system analogous to the US Federal Reserve System, in which exchange rates became fixed and monetary policy was decided centrally, in a way that is binding for national central banks.

those models?

is this a bit?

III. THE CURRENCY OF THE UNION

1. A common currency. A crucial question is whether a monetary union, in which the monetary policy process is unified for the entire area, requires a common currency (single currency) or, else, is compatible with a plurality of national currencies (multicurrency).

- Could a monetary union be entirely multicurrency, i.e. be constructed without a common currency? How could this be done? In this case what ~~instruments~~ would be used to achieve a coherent and unique course of monetary policy?
- If a common currency was considered to be necessary, what features should it have in terms of definition, convertibility, conditions for issuing it, etc.?
- If by a parallel currency we mean a currency that circulates alongside existing national currencies, what would be its role and definition? What contribution would it be expected to bring to the monetary union and, particularly, to the conduct of monetary policy? How would monetary stability be ensured? Should the use of the common currency be actively promoted? If not, would its use spread spontaneously to the point of becoming the currency of the Community?

could be FCU because the common currency

Common

- parallel
- dominant
- unique

60

- fixed, self
ex. r
between
any common
currency -
national
currency*
- What should be meant by a single currency? Does the concept of a single currency imply that such currency should completely replace existing national currencies? If not, what would be the relationship between national currencies and the single currency? What would be the difference between a single European currency and a parallel currency? Can it be envisaged that the single currency role is played by one of the national currencies prevailing over the others? Should the common currency play a "disciplinary" role analogous to the role that used to be played by gold? If the common currency did replace national currencies, how would the replacement be made?
 - What should be the international role of the common currency in the various hypotheses? What its relationships with the dollar and the yen?

2. The ECU. The ECU has developed various functions in the Community budget and operations, in the EMS mechanisms, and in financial markets. These developments resulted partly from official action, partly from the initiative of market participants. Several questions arise about the position and role of the ECU in a monetary union.

- Do the existing status and function of the ECU correspond to the concept of a parallel currency? What, if any, new provisions should be envisaged regarding the creation of private and official ECUs? Should the two (private and official) "circuits" be linked? In what way? What is the potential for a further spontaneous development of the ECU in its present form and what risks does it entail?
- What are the advantages and disadvantages of the basket definition of the ECU? Under what circumstances should the basket definition be abandoned? What steps should be taken to improve the quality of the ECU?
- If the solution of a single currency were chosen for a monetary union, what would be the role of the ECU? What changes would have to be introduced to make the ECU fit into this scheme? What relationship would there have to be between the ECU and national currencies?

IV. THE MONETARY AUTHORITY

1. Mandate. To operate effectively, a monetary union would require a set of rules, but also an authority. Various ideas and proposals have been put

forward through the years. The Committee's Report will have to examine them.

- 2
- What can be the role of a precise and clearly stated responsibility of the Monetary Authority of the Union to follow the primary objective determined under II.1 above?
 - What decisions and operations will it have to be responsible for?
 - What would be the role of the Authority in international monetary relationships?
 - Should the monetary Authority exert functions in the field of banking supervision?

2. Operations and Instruments. Inflation and interest rates are the same throughout a monetary union. The question arises as to the role the monetary Authority will play in determining their levels.

- What kind of operating instruments will the Authority have? Should it be empowered to operate directly in money, financial, and foreign exchange markets? Will it operate indirectly through other banks or central banks?
- What regulatory powers with regards both to national central banks and to commercial banks (e.g. imposition of compulsory reserves) will have to be granted to the monetary Authority?

3. Organs and decision making. The organizational structure and the decision-making process of the monetary Authority will presumably have to reflect the plurinational character of the Community.

- of monetary
institutions?*
- Would the organizational structure be dependent on the chosen model? In which way?
 - What organs should the monetary Authority have?
 - What decision making and voting procedures should be adopted?
 - How should the members of the governing bodies of the Authority be chosen? How long would their term of office be?

4. The monetary Authority in alternative models of MU. The Committee will presumably discuss the functions, instruments and structure of the monetary Authority in various alternative models of Monetary Union, such as those outlined in II.4 above. Special questions arise for the models, others than the "centralized" one.

- What would be the functions of such an Authority in a "decentralized" model? Would these functions differ from those exerted today by the existing Committees?
- In a model of parallel currency what would be the relationship

between the Authority in charge of such a currency and national central banks?

- If the monetary Authority had a "federal" structure, what would be the respective roles of the central (federal) bank and of the local (national) central banks in a) the governing bodies of the system, b) the policy decisions and functions and c) the execution of policy and market operations? Would this model leave room for a circulation of national currencies supplied by national central banks? How would this supply be determined?

V. LEGAL AND INSTITUTIONAL ISSUES

1. Non monetary aspects. The Single European Act and the 1992 programme contain a structured set of economic and regulatory actions for the achievement of an economic Union.
 - Is this programme sufficient to provide the EMU with an adequate legal and institutional basis concerning the "economic" (non-monetary) aspects?
 - Are other legal and institutional steps to be taken in the non-monetary field? What should be such steps?
2. Legal basis for a MU. Article 102 of the Single European Act states that further development in the field of economic and monetary policy necessitating institutional changes should be based on article 236 of the Treaty of Rome, which implies the accord of an intergovernmental conference and ratification by member states.
 - Is there room still available for "non-institutional" progress towards a monetary union, i.e. for progress based on the existing legal arrangements? In particular, can the monetary policy decisions of national authorities be bound by decisions taken by one of the existing Community organs (Monetary Committee, Council of Ministers, Committee of Governors, EMCF)?
 - What kind of legal instruments are necessary to allow a monetary union to come into force? Is the EIB (European Investment Bank) formula, based on articles in the Treaty of Rome and Statutes, both ratified by member states, to be regarded as a useful model? What other models should be considered?
3. Independence and accountability. It is often stated that a European monetary Authority should be independent.

- What meaning should be given to the concept of independence? What institutional, legal and organizational provisions would be necessary to grant independence?
- If independence implies that the monetary Authority is given the status of a "Community institution" (like the Council, the Commission, the European Parliament, the Court of Justice) what should be the relationships between the authority and the other Community institutions?
- To whom should the Authority be accountable? What forms should this accountability take? Should there be provisions requiring the policy decisions of the Authority to be consistent with general economic policies formulated by the Community?
- Who would appoint the members of the decision-making bodies of the Authority?
- Is the choice of the location of the monetary Authority relevant from the point of view of its status? What criteria should be considered in the choice of the location?

VI. STEPWISE IMPLEMENTATION

1. Main phases. The previous sections were focused on the final stage of the EMU in view of the difficulty and risk of defining or taking intermediate steps without a clear notion of the direction. According to the conclusions of the Hannover Council, however, this end result is to be reached by concrete steps, which presumably means excluding both a big "leap" and an imperceptible "creep". To formulate suggestions for "concrete steps", the Committee will have to form its views about the features of a limited number of important steps, and the logics of a stepwise process.

- What should be the relationship between economic and monetary steps towards the EMU? If a new legal and institutional basis is necessary to establish a monetary union, should it contain explicit references to developments in other areas? If in the monetary field the end result must be agreed before concrete steps are taken, how should a new Treaty define the entire process?
- What should be the "critical quantum change" necessary to make each step significant? Should such change be equally distributed between the institutional and the operational aspects? Or should the institutional and legal basis be put in place fully from the beginning?

- What would have to be the content of the phase to be implemented by 1990, i.e. when complete mobility of capital will come into force?
- How many steps should be proposed?

2. Moving from one phase to another. Stepwise implementation will presumably involve an agreed procedure to move from one phase to another.

- What would be the appropriate combination of automaticity and discretion in the passage from one phase to another?
- Should there be a sort of timetable, as in the early phase of Community integration or, more recently, in the liberalization of capital movements?
- Who should decide the passage from one phase to another? How should these decisions be shared between the monetary authority of the Union and other Community institutions?

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Should specific criteria be met before the next phase is entered?

Could it be possible & desirable to advance at different speeds that different groups of countries?