COMMITTEE FOR THE STUDY OF ECONOMIC AND MONETARY UNION

20th October 1988

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Second meeting of the Committee in Luxembourg
10th October 1988

The meeting was held at the Centre Européen. It started at 10.00 a.m. and ended at 5.30 p.m.

The meeting was devoted to a discussion of the characteristics and implications of an economic union consistent with a monetary union. The discussion was organised around three main issues: problems arising in a situation of irrevocably fixed exchange rates; policies needed to deal with these problems; and institutional arrangements required to formulate and execute such policies. The Committee also had a first exchange of views on an outline for the final report and commissioned two short studies on countries' experiences with transfer policies and budgetary policies in federal states.

1. Problems arising in a situation of irrevocably fixed exchange rates

There was general agreement that a monetary union gave rise to two interconnected problems: firstly, as the exchange rate ceased to be an instrument of adjustment other mechanisms would have to take its place in order to eliminate, or at least reduce significantly, economic imbalances among member countries of the union; secondly, the fixity of exchange rates in conjunction with the disappearance of national balances of payments removed an important warning signal for divergent developments. Impending imbalances would be less visible at an early stage and it would therefore be more difficult to ensure an adequate co-ordination of policies and convergence of performance.

All Committee members were of the view that market forces operating through changes in nominal wages and prices and movements of factors of production could not be expected to substitute fully for the role played presently by the exchange rate. However, views differed about the seriousness of problems that might arise. Thygesen and Ciampi felt that, on the assumption that monetary policy was pursued by an independent institution which would not have to finance government budget deficits, fixed exchange rates would exert strong disciplinary effects on the behaviour of market participants and governments and that therefore large imbalances were not likely to develop. Thygesen also argued that the importance of the exchange rate as an adjustment instrument had declined since the dismantling of indexation schemes and converging performance within the EC had lessened countries' differences in sensitivity to external shocks and third currency fluctuations. Other Committee members were more sceptical. Pöhl emphasised the importance of a tight, stability-oriented monetary policy, but also saw the need for complementary policies in support of market forces. Others (de Larosière, Lamfalussy) stressed that emerging imbalances would be less perceptible and that adjustment brought about by private market participants worked more slowly than adjustment guided by government policies. Several speakers (Chalikias, Godeaux, Hoffmeyer, Moreira) had little confidence in the disciplinary effects of market forces and Boyer felt that fixity of exchange rates could reasonably be considered only at a much more advanced stage of convergence.

2. Policies needed to deal with problems

The discussion of policies required to reinforce the equilibrating effects of market forces in a single-currency area centred on two areas: transfer policies and budgetary policies.

Financial transfers were generally considered to be an indispensable element to mitigate an adjustment process that, if left entirely to the working of market forces, might entail excessive economic costs in terms of employment and output for less competitive or structurally weaker countries in the union. It was emphasised that transfer policies would have to distinguish between imbalances generated by policy divergences, different wage behaviour and differing responses to external shocks and imbalances rooted in structural differences, reflecting the different stages of countries' economic development at the time of the establishment of the union (Hoffmeyer); it was, however, recognised that it would be difficult to draw a clear distinction between these two types of imbalances during the running-in period of the union (Andriessen). In designing transfer policies, a number of criteria were mentioned: transfers should not impede the working of market mechanisms (Hoffmeyer, Pöhl); transfers should not aim at reducing income disparities but be directed at the investment in infra-structure, communication and education (Doyle); and transfer payments should not be assessed solely in terms of volume but also in terms of quality - for instance, if transfers were combined with technical assistance on the basis of partnership (Delors). It was also pointed out that transfers as an alternative to exchange rate changes would meet narrow limits. While, for instance, a devaluing country would bear the consequences of its domestic policy management, receipt of transfers would make the country wealthier - a fact that was likely to be resented by tax payers in the countries financing the transfers (Leigh-Pemberton). Moreover, as long as significant structural divergences persisted, transfer payments would have to be of a magnitude unacceptable to tax payers. For this reason Boyer felt that the transfer problem was more difficult to solve than issues relating to macro-economic policy harmonisation.

As far as budgetary policies were concerned there was broad agreement that a certain measure of co-ordination of national policies was needed. Since co-ordination was not expected to be brought about by market pressure alone, discipline on national authorities would have to be imposed within a framework of mutually agreed binding rules. However, fully centralised budgetary policy was not needed and as much autonomy as possible should be left to national authorities (de Larosière, Lamfalussy, Duisenberg). Two ideas were advanced on how to possibly formulate binding rules: within national budgets current expenditures should be covered by ordinary revenues, leaving only the possibility of borrowing for the financing of investment expenditures (Duisenberg); or national budget deficits should be limited to a maximum percentage of GNP (Lamfalussy). Moreover, rules governing borrowing in non-Community currencies were also required (Leigh-Pemberton). At the same time it was considered desirable to maintain some flexibility and discretion, especially since the outcome on budgetary positions as a result of automatic rules might not be appropriate in the light of overall fiscal policy requirements (Leigh-Pemberton).

3. Institutional arrangements

There was general agreement that a monetary union (implying one monetary policy and a certain degree of budgetary policy harmonisation) would require an institutional framework within which the necessary policy decisions were to be made. The Committee did not enter into a discussion of the specific features and characteristics of the decision-making centres, but focused on the question of which legal changes were required for the establishment of the decision-making centres and which approach should be chosen. Given that the surrender of decision-making power with regard to monetary and budgetary policies to a Community body would necessitate changes in national legislations, several Committee members (Duisenberg, Doyle, de Larosière, Pöhl) expressed a clear preference for a solution in the form of a treaty which would lay down the tasks, objectives and operational features of future decision-making bodies as well as the provisions for their implementation in stages. Only if Community institutions were strengthened by a firm treaty would it be possible to achieve and enforce the necessary degree of co-ordination of budgetary, regional and incomes policies (Doyle). The different nature of policies was seen to have significant implications for the type of the institution put in charge of policy formulation and execution. While for budgetary policy decisions it was conceivable to strike a balance between rules (contained in a treaty) and discretion (leaving room for negotiations between national governments), monetary policy was a day-to-day operation in response to changing market conditions. For this reason it seemed inevitable that monetary policy had to be decided by an autonomous central bank (Lamfalussy). De Larosière, Duisenberg and Pöhl agreed that in the final stage an autonomous monetary authority was needed and that its establishment would be meaningful only if at the same time budgetary policies were co-ordinated.

In the context of the discussion of institutional questions there was a brief exchange of views on the concept of a two-speed integration. It was concluded that the report should not go into the question of what would happen if some countries rejected the notion of a union. But the report should deal with the possibility of some countries, which subscribe to the final objective, being granted a longer period of transition (similar to the procedure agreed for the liberalisation of capital transactions).

4. Outline of the report

In accordance with a proposal by Pöhl it was agreed that the Committee's report should have three main chapters:

1. The final objective;
2. The present state of economic and monetary integration in the Community;
3. Concrete steps towards economic and monetary union.

Pöhl suggested that the first chapter should include a description of the principal characteristics of economic and monetary union, the policy objectives, the relations with the rest of the world and the federal and decentralised character of the union. The second chapter would take stock of the achievements made so far in the process of integration, with particular reference to the present degree of integration in markets for goods and services and the progress expected to be made by 1992 in the context of the single market programme. This chapter would also emphasise the close monetary co-operation in the framework of the EMS and the convergence in other policy areas and in economic performance in recent years. The third chapter would set out concrete steps leading to the final objective of economic and monetary union. It would state the objectives to be attained by individual concrete steps and deal with structural policies and transfer mechanisms, the harmonisation of budgetary policies (including the description of possible criteria for maximum permissible national budget deficits), the need for full participation of all countries in the exchange rate mechanism of the EMS, issues relating to capital liberalisation and measures to co-ordinate monetary policy. While this latter point should include proposals for strengthening the Committee of Governors, it might be difficult for the Governors themselves to ask the Heads of State for an increase in their own responsibilities. Measures to increase the powers of the Committee of Governors might therefore have to be recommended in a separate letter by Delors, in his capacity as Chairman of the Committee for the Study of Economic and Monetary Union.

In comments to Pöhl's suggestions on the report de Larosière emphasised that it would be extremely important to describe fully all stages leading to economic and monetary union, to cover institutional questions and to formulate a first step for closer monetary co-operation that involved some (limited) transfer of power to a body which would evolve later into a central bank. Boyer, however, argued that the individual concrete steps should not be linked too closely to the final objective. It might be that some countries would find it difficult to subscribe (at least initially) to the transfer of sovereignty implied in the final objective, but would be willing to accept certain concrete steps. In other words, concrete steps should not necessarily be justified by the final objective but should be judged on their own merits.

5. Supportive studies and additional papers

Ciampi: A paper on the ECU (the present situation, spontaneous developments; institutional arrangements).

Commission: A note on regional policies and transfers, with particular reference to the present volume of financial transfers, the optimum volume according to the Padoa-Schioppa report and the increase in the Community's structural funds.

A note on the management of budgetary policies in federally organised countries, with particular reference to the United States, Canada and Germany, looking at the degree of budgetary centralisation and financing limits on local authorities' budgets.

Hoffmeyer: Submitted a questionnaire aimed at ascertaining when, for which purpose and to what extent legal changes were required in each member country in the process of creating Community institutions. The questionnaire should be reviewed and possibly modified by the rapporteurs and then be distributed for completion to the central bank governors on the Committee.

6. Future work programme

It was decided that the Committee's meeting on 8th November 1988 should be devoted to the definition and implications of a monetary union. As background information to the discussion the following three papers would be circulated to Committee members before the meeting:

Godeaux: The experience with the EMS.

Thygesen: A European system of central banks.

de Larosière: First steps on the way to monetary union.

It was also decided that the rapporteurs would prepare a twenty-page skeleton of the report along the lines of the agreed outline for the Committee's meeting in December.