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Rome, 2 ebruary 1989

Dear Gunter

this is the draft of part I. It still needs many improvements as well as completion. The contribution from Brussels is particularly important for par. 1,2,8. We could speak on the phone tomorrow morning, if you can.

Best regards,

Tommaso

Provisional draft
2nd February 1989

I. The present state of and perspectives for economic and monetary integration in the Community

1. Introduction

1. This section will briefly recall the main features of the process of economic and monetary integration in Europe since the beginning of the 1970s. In particular, it will make reference to:

- the Werner Report, which presented a first attempt to define and set out a plan for the attainment of economic and monetary union;
- the perception by the mid-1970s that the process of integration had lost momentum; nonetheless, a number of significant developments took place in the Community both in monetary areas (notably the establishment of the EMS) and in non-monetary fields;
- the new impetus to European integration in the mid-1980s, as reflected in the adoption of the internal market programme and the signing of the Single European Act;
- the fact that progress in one area has promoted advancement in other areas and that integration has now reached a stage where it is practically irreversible.

2. The section will conclude with a brief statement to the effect that the Community has proved able to overcome serious problems, has expanded as a result of the accession

of new member countries and has revived the idea of economic and monetary union. In particular, it will stress that the Community is now on the move and that it has put its house in order by resolving the most urgent budgetary and policy issues.

2. The EMS and the adjustment of the European economy

3. In the monetary field a new phase in the process towards an economic and monetary union opened with the creation of the European Monetary System at the end of the '70s. The progress made by the Community in the '80s towards price stability, fiscal and structural adjustment, and greater economic integration owed much to the European Monetary System.

4. Within the framework of the EMS the Community has developed into a zone of increasing monetary stability and open internal trade, in a period in which the world economy was shaken by wide exchange rate fluctuations and tensions in trade relationships. The acceptance of the exchange rate constraint has greatly assisted the participating countries in gearing their monetary policy towards the objective of price stability, thereby laying the foundations for both a converging price performance at a low rate of inflation and the achievement of a high degree of exchange rate stability. Moreover, the greater priority given to a policy of monetary stability has contributed, in many countries, to a process of economic adjustment obtained through budgetary restraint and moderation in cost increases, and leading to an improvement in the overall performance of the economy. Finally, the reduced uncertainty about exchange rate developments and the fact that the parities of the participating currencies were not allowed to significantly depart from the fundamental economic conditions of the respective countries, created a

acceptance of price stability as a po

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condition favourable to the maintenance and strengthening of open intra-European trade, even in a period of great economic difficulties and severe unemployment.

The EMS has served as the focal point for improved monetary policy co-ordination and provided a basis for multilateral surveillance within the Community. Its success is in part attributable to the willingness of countries to opt for a strong currency policy stance, but also to the flexible and pragmatic way in which it has been managed. The System has evolved in response to changes in the economic and financial environment and on two occasions (Palermo 1986, Basle-Nyborg 1987) its mechanism have been amended and improved.

5. The launching of the European monetary system was accompanied by the creation and development of the ECU, that replaced the European unit of account. In setting up the EMS , the European Council declared in 1978 that "a European currency unit (ECU) will be at the center of the EMS.". Apart from ~~Beyond~~ being used as the denominator of the deposits with the EMCF obtained against gold and dollars conferred through the swaps mechanisms, and as a denominator of intra-EMS credit facilities, the "official" ECU has had a limited developmeent and role in the EMS so far. The use of the ECU by private markets, however, has spread significantly, as an international currency partly because of the intrinsic advantages presented over certain Community currencies, partly as a result of a perception that it could become the future currency of Europe. ?

The ECU has strongly developed as a financial instrument in private markets. In international banking it has become the sixth currency of denomination. The creation of an ECU clearing system two years ago, in which participate now more than thirty commercial banks, has contributed to the development and the liquidity of the market. The ECU also ranks fifth as a currency of denomination of international bond issues, with 6 per cent of the market. A wide set of new instruments is now available for investors, both with short and long maturities. In the non-financial sphere the use of the ECU remains limited, because of the scarcity of information and the difficulty to introduce innovations in the currency denomination of commercial transactions. However, opinion polls, especially among firms, tend to show an increased interest in the potential uses of the ECU. The EC Commission has launched several initiatives in this field.

Explain

3. The Single European Act and the Internal Market Programme

6. On the economic side, a "relaunching" of Europe began in the mid-80s. The central element in this process was the proposal, made in May 1985 by the Commission, to realise the objective of a market without internal frontiers by 1992. The essence of the measures for the removal of physical, technical and tax barriers was set out in a White Paper, which specifies the programme, timetable and methods for creating a unified economic area in which persons, goods, services and capital will be able to move freely. This objective, together with the necessary institutional means, was embodied in December 1985 in the Single European Act which marked the first significant revision of the Treaty of Rome.

7. The Single Act signalled two significant changes in the Community's strategy to advance in the integration process. Firstly, it incorporated an institutional reform aimed at establishing a faster, more efficient and more democratic decision-making process which was considered to be indispensable for reaching the goal of a common unrestricted market. In particular, this reform extended the scope of qualified majority voting and thereby removed the constraints

inherent in the permanent search for consensus which had hampered the decision-making process in the past; gave the European Parliament a greater role in the legislative process; drastically simplified the requirements of the harmonization of national law by systematic adoption of mutual recognition of national norms and regulations. Secondly, with the Single Act the member countries reaffirmed - and recognised in the context of the Treaty of Rome - the need to strengthen the Community's economic and social cohesion, to enhance the Community's monetary capacity in the perspective of Economic and Monetary Union, to reinforce the Community's scientific and technological basis, to harmonise working conditions with respect to health and safety standards and to promote the dialogue between management and labour, and to initiate action to protect the environment.

8. Concerning the implementation of the single market program, the progress made in the last three years (Spring 86 to Spring 89) is very significant and highlights a complete change of pace in approaching a unified market, as compared to the more than twenty previous years.
....(Some figures could follow to sustantiate this proposition: number of directives approved in 1986-88 as compared to the yearly average of previous years; average time elapsed between Commission's proposals and Council approval in the last three years and previously; number of directives proposed by the Commission to the Council. Also, some information about the main areas involved: financial services, public procurements, technical norms, standards, etc. Finally, some information concerning the "executive" function related to the single market: competition policy carried out by the Commission, activity of the European investment bank, other examples.)....

Concerning the Community policies accompanying the creation of the single market, a package of measures was approved by the European Council in February 1988. These

policies included decisions to better adapt the common agricultural policy to market conditions, to double the resources of the structural funds in order to assist less developed regions or adjustment in declining industries, and to provide the Community with sufficient and stable financial resources.
....(expand)....

4. Perspectives, opportunities, problems

9. The European Council, meeting in Rhodes in December 1988, noted that "at the halfway stage towards the deadline of December 1992 half of the legislative programme necessary for the establishment of the large market is already nearly complete" and underlined "the irreversible nature of the movement towards a Europe without internal frontiers".

Among economic agents, the objective of a large market without internal frontiers enjoys broad support, emanating to a significant extent also from the dynamic forces that the objective of 1992 has created at every decision-making level. In the private sector the anticipation effects are clearly reflected in the investment strategies of European firms and the unprecedented number of mergers foreshadowing the intensification of industrial co-operation. The prospects of a single market, the credibility of the member countries' desire to move towards a highly integrated Community and the enhancement of the decision-making capacity of Community bodies are having a strong impact on the behaviour of market participants in the Community.

10. The advantages deriving from the completion of the internal market are, in terms of economic welfare and greater freedom for the European people, deep and widespread because of the very deep structural change in the European economy required and promoted by the establishment of the single

market. Such change will not only involve regulatory and other policy aspects for which a competence will have to be established at the Community level. It will also invove the conditions under which will be exerted policy functions that remain a preserve of national authorities. This is so because the degree of economic interdipendence among member countries will be significantly strengthened by the single market, thereby enhancing the repercussions that each economy will receive from impulses originated in other member states. In the economic field, the dismantlement of all physical, regulatory and tax barriers in the exchange of goods and services will increase and accelerate the cross-frontier effects of cost and budgetary developments originating in each member state. In the financial and monetary field, this effect is going to be even stronger, following the complete liberalization of capital movements that will become effective in most member countries by mid-1990.

11. The maximum benefit from the creation of the single market can be brought about only through <u>more stable exchange rates and closer coordination of economic and monetary policies</u>. An efficient allocation of economic resources in a wide, integrated space will only be possible in a framework of exchange rate stability. If the flexibility and scope for parity adjustments offered by the present EMS arrangements were to be intensively used to cope with pressures on exchange rates originating from financial disturbances, real exchange rates would depart from economic fundamental conditions and investment and consumption decisions by economic agents would be made inefficient by such misalignments. In order to avoid such developments a close degree of macro-economic policy and monetary policy coordination is indispensable. A lack of coordination would inevitably lead, sooner or later, to mutually inconsistent policies being conducted in different countries. Such inconsistency would eventually produce imbalances in

balance with cancellation of real ex. r. misalignments caused by parity changes

Community exchanges of goods and services and would, in turn, feed the illusion in some political quarters that the tensions could be relieved by protecting some sectors of the economy through a real exchange rate change rather than by adopting the appropriate structural or macro-economic policies. This would induce a slowing down in the process of opening our economies or even a rethinking of some of the steps already taken. Economic agents would be inclined to take full account of the single market in their economic decisions only if they were strongly convinced that the single market is going to last. The perception that the move towards a single market indeed "irreversible" would not be solid without the support of a significant enhancement in the degree of policy coordination.

12. Economic and monetary union has been set as a goal by the Community from the late sixties. The single market, by itself, does not require as a precondition the establishment of an economic and monetary union. It requires, however, a significant increase in the degree of economic policy cooperation even in areas that are not, as such, part of the single market program. Such increase represent a progress in the path leading to an economic and monetary union. This is the reason why the European Council in Hannover has decided to consider again the problem of an economic and monetary union and the steps leading to it. These are the subject matters of Parts II and III of this Report.