CONFERENCE
OF THE REPRESENTATIVES OF THE GOVERNMENTS
OF THE MEMBER STATES
- ECONOMIC AND MONETARY UNION -

Brussels, 31 January 1991

CONF-UEM 1610/91

R/LIMITE

NOTE

Subject: Preparation of the Intergovernmental Conference on EMU

Delegations will find herewith the note from the Spanish Government dated 25 September 1990 and entitled "EMU: staying the course".

EMU: staying the course

(A proposal for a successful InterGovernmental Conference)

I. Introduction

On September 8, during the informal ECOFIN in Rome, Spain put forward a compromise proposal, aimed at a number of important goals: the creation during Stage two of the operational and institutional framework which will ensure adequate economic convergence, a key element in the road towards full EMU; the agreement on some broad timetable which, while allowing for flexibility and for not unduly short a Stage two, will keep at all times the political momentum of this major endeavour and will facilitate the convergence process; the design of the process towards full EMU as a joint effort of all twelve member states and the Community as such; the establishment of objective conditions for the transition from one Stage to the next, as a test of the real commitment of the member countries and the Community to make convergence and economic and social cohesion a reality; and to incorporate into the technical design of the transition process those recent suggestions on the ECU which can nicely fit into the original Delors Report, as endorsed in the European Council of Madrid, and pave the way for the ECU to become the single Community currency.

Insofar, Spain's proposal stayed well away from any suggestion which could be deemed to depart from the original Delors Report and from the political understandings already achieved by the European Council.

Hereafter such compromise proposal is spelled out, again, in more detail, in the sincere hope that it will contribute to the success of the forthcoming InterGovernmental Conference.

II. Departures from the Delors Report

Since it was endorsed by the European Council of Madrid in June 1989 as the basis for future progress towards the Economic and Monetary Union (EMU), the Delors Report has been challenged from three different perspectives.

First of all, the United Kingdom has presented a well known alternative to the Delors Plan, which has evolved over time and has recently incorporated some new technical aspects to be referred to later in this document.

Besides, in a much more unconspicuous way, during the process of discussion of the Delors Report two additional views have emerged which depart significantly from the balanced approach of the Report. The first one can be seen as an effort to speed up the process towards full EMU in the wake of the momentous changes which have taken place in Eastern Europe since the Madrid European Council took place. The second one may be regarded as a new manifestation of the unreconstructed resistance by some to any "institutional" progress short of full EMU, an attitude which, in fact, can boast of having succesfully blocked the creation of the European Monetary Fund envisaged by the European Council in 1978 when the current EMS was created.

In order to bring out the differences between these two relatively recent views and the Delors Report, it is worth recalling some aspects of the latter.

First of all, paragraph 41, under the heading "Discrete but evolutionary steps", refers to the need to divide the process of implementing economic and monetary union into a limited number of clearly defined stages, so that " each stage would have to represent a significant change with respect to the preceding one". According to paragraph 55, in the second stage "the basic organs and structure of the economic and monetary union would be set up ... The institutional framework would gradually take over operational functions ... 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". As to the actual timetable for the transition process, the Report makes no specific proposal, but in paragraph 62 it considers, and does not reject, the possibility of concluding "a new Treaty for each stage", something which, given Parlamentary procedures for ratification of Treaties and the need to negotiate a second one, would presumably require Stage two to take several years. Furthermore, paragraph 43 attaches particular weight not to set explicit deadlines for the passage from Stage two to the final stage, which will require an appraisal "in the light of the experience gained in the preceding stage". As regards the real content of Stage two, paragraph 57 recognises candidly that "at this juncture, the committee does not consider it possible to propose a detailed blueprint for accomplishing this transition (of decision making power from national authorities to a Community institution)".

Now, as stated above, during the preparatory work of the Inter Governmental Conference the idea has been floated that the Stage two could be dispensed with altogether or, alternatively, compressed into such a short timespan that it would hardly be more than the technically minimum period before Stage three becomes institutionally and legally fully operational. To allay the well known fears of those concerned by insufficient convergence among the twelve member countries, this view has more or less explicitly assummed that a two-speed approach was inevitable, with several countries likely to fail to meet an early "convergence-test" being unable to graduate into Stage three. According to this view, this division is seen certainly as regrettable, but will need to be accepted even if those countries left behind are almost as numerous as those moving forward, and, in some cases, have made remarkable progress in their catching-up process.

Furthermore, another view has emerged, probably as a hedge against too hasty a Stage two, which argues in favour of a Stage two not involving any meaningful institutional change at all or just a transformation of the current Committee of Governors into a so-called "Council of Governors", with the future "European System of Central Banks" being established just before the start of Stage three.

If we now compare these two theoretical ideas with the Delors Report, it should be apparent that the first one is hardly consistent with a gradualist aproach and might require the division of Europe into different monetary zones, something at odds with the spirit of the Madrid, Strasbourg and Dublin European Councils of all countries moving forward jointly towards EMU. And the second one, by advocating a Stage two which is indistinguishable from Stage one, fails to produce real institutional change, will not create institutional pressure for convergence during Stage two and violates the key principle of "discrete but evolutionary steps" agreed by the European Council in Madrid in June 1989.

Spain firmly believes that none of these three approaches is consistent with the basic agreements already reached by the European Council over the last two years. Consequently, it feels that the Inter Governmental Conference must <u>stay the course</u> and stick to the substance of the original Delors Report, shying equally away from <u>postponing</u> indefinitely Stage three, <u>dispensing</u> with a meaningful Stage two or <u>replacing</u> Stage two by an extended Stage one. This two latter approaches seem particularly ill-advised at a time when the UK has already accepted the need for a meaningful and distinct Stage two. The third approach should be of especial concern, in light of the previous monetary experience in the Community, in which the institutional mechanisms envisaged in official texts either failed to materialise (e.g. the "European Monetary Fund") or remained purely nominal artifacts devoid of any practical weight (e.g. the current system of official ECU deposits in the FECOM).

III. <u>Spain's proposal</u>.

1. The contents of the Stage two.

Chapter III of the Delors Report presents a very compelling case for a "step-by-step" approach, guided by the principles of "parallelism" and "discrete but evolutionary steps". Many of its arguments need not be repeated here. It will suffice to recall that full economic convergence will not be achieved overnight: multilateral surveillance procedures, including in particular growingly binding procedures on public sector budget deficits (something which, incidentally, will require a serious methodological work to allow meaningfull comparisons among national budgetary figures) will take time and effort to yield results; and long ingrained economic and psychological habits (as regards, for instance, wage bargaining, inflation expectations or risk premia implicit in nominal interest rates) will change only gradually. Besides, the need for paralellism between economic and monetary progress, including the need for the Community budget to take on gradually a more important role, argues also in favour of not too short a Stage two.

For Spain, the creation of a new monetary institution from the very beginning of Stage two will be critical for this enhanced economic convergence, a job whose difficulty should not be underestimated. Besides, the new institution will also be extremely useful for the preparation of the technical groundwork required in Stage three to carry out the single monetary policy (whose technical intricacies and difficulties have already become apparent in the preliminary discussions held within the Comittee of Governors).

The new monetary institution ought to be totally independent from national Governments and EEC institutions, and ought to be designed so as to be transformed easily into the final "European Central Bank" before Stage two ends.

As stated above, the Delors Report openly acknowledged in paragraph 57 that, in the monetary field, it had not been able to prepare a detailed blueprint for accomplishing the gradual transfer of decision-making power from national authorities to the new Community institution. This statement amounted to a clear invitation for further work to fill this gap and define more precisely the role to be played by the new monetary institution to be created in Stage two(*).

(*) It should be recalled that paragraph 53 of the Delors Report itself contains a discussion of a proposed "European Reserve Fund" to be created during the first Stage, an idea which did not win the general aproval of Committee members on grounds which applied mainly to Stage one.

For Spain, the recent proposal by the UK Treasury about a new "European Monetary Fund" (EMF), to be created immediately after the start of Stage two and vested with powers to issue "hard ECUs", is not indeed the only alternative possible, but seems a reasonable and serious attempt to fill the gap mentioned in the Delors Report, provided it is seen as a temporary one, before the Community enters Stage three and the ECU becomes the single EEC currency. In fact, this political committment to Stage three is not only necessary to be consistent with the final goal to achieve a real EMU, but will be absolutely necessary for the market to see the "hard ECU" as something worthwhile.

A preliminary analysis would suggest that the British "hard-ECU" plan might have potential advantages over a mere redefinition of the ECU as an "adjustable basket": on top of implying the creation of a new monetary institution with a clearly defined task, it would facilitate the growing acceptance by EEC citizens and firms of the ECU, the development of the ECU market and the creation of an efficient ECU-based Community-wide payments network, something important to maximize the benefits of a single currency. Furthermore, the determination by the EMF of its interest rate policy with respect to the "hard-ECU" would need to take into account, as well as influence, the policies pursued by national monetary authorities, and would provide a natural training ground for monetary policy coordination, something which, far from being a disturbing feature of the scheme, is of the very essence of Stage two according to the Delors Report.

The "hard-ECU" plan not being a cut and dried one, it might allow for a number of specifications, additions and changes. Thus, as to the name of the new institution, the one proposed by the UK, "European Monetary Fund", although already used in 1978 to describe the new institution to be created during the "institutional" phase of the EMS, might not be now necessarily the most appropriate, if only because, as currently envisaged, the "EMF" is not really a "fund" but a genuine "bank". Furthermore, additional roles could be assigned to the EMF other than issuing "hard-ECUs" and regulating its market (for instance, intervening in foreign exchange markets on behalf of national authorities, as envisaged in the "European Reserve Fund" proposal mentioned in paragraph 53 of the Delors Report).

2. The start of Stage two.

The Delors Report deemed not advisable to set explicit deadlines for the passage from one stage to the next (paragraph 43), leaving that decision to the European Council and, from Stage two to Stage three, also to the European System of Central Banks.

The European Council of Dublin has already expressed the wish that the new Treaty be ratified by all member countries by the end of 1992. And, although no agreement has intervened yet on the actual entry into force of Stage two, it would be inconsistent with the spirit of the European Council's decision to envisage too long a "vacatio legis" between the deadline for complete ratification of the Treaty and its entry into force.

In light of this, Spain is proposing for that "vacatio legis" to be of only 1 year, so that Stage two formally begins on January 1st, 1994. This timetable should provide member countries and the Community with a one-year experience with the full Single Market, and should offer some leeway in case any of its measures (for instance, on tax harmonisation) were to be approved with delay. Furthermore, it should allow member countries to meet by December 1993 the following conditions for passage to Stage two(*):

i) All Community currencies participate in the Exchange Rate Mechanism.

Although paragraph 52 of the Delors Report does not explicitly envisage any exception to this principle, Spain, bearing in mind the procedure followed when the EMS was created, could accept that a wider fluctuation band be considered for some currencies at the beginning of Stage two.

ii) National Treasuries' access to national Central Banks and any other way of compulsory public deficit financing are strictly forbidden.

(*) No explicit reference is made to the total freedom of capital movements in so far as it will have to be in force in all countries by December 1992, except if Portugal and Greece were granted the additional 3 year derogation period envisaged in article 6.2 of the 1988 Directive.

iii). <u>Central Governments' savings are not negative</u> (i.e. Central budget deficits do not exceed gross investment). "Golden rule"

iv) <u>National Central Banks are recognized full independence from Governments</u>.

Passage to Stage two should take place at the beginning of 1994, provided these conditions have been met.

3. The end of Stage two and the passage to the final Stage.

<u>Stage three must be regarded as an absolute certainty to follow after Stage two</u>, although passage to Stage three should not take place according to a preestablished shedule.

Furthermore, as explained above, the Delors Report envisages a substantive Stage two, to the point that it explicitly considers the possibility of the Stage two being the only object of a new Treaty, to be followed by another one for the final Stage.

Consistent with the Delors Report, bearing in mind that passage to the Stage three should not be automatic and will require an appraisal by the European Council and by the European System of Central Banks in the light of the experience gained in Stage two (paragraph 43), but in the spirit of helping accelerate the convergence process necessary for EMU to be a success, Spain considers that a <u>5 or 6 year Stage two</u> should be reasonably expected to be long enough for the overwhelming majority of countries, if not all, and for the Community as such, to meet the required <u>conditions</u> for passage to Stage three, which could be expressed as follows:

i) All member countries are already in strict compliance with all the budgetary rules to be enshrined in the Treaty, as developed in any derived Community legislation.

ii) Inflation rates have already converged to a sufficiently low level.

iii) Differentials among nominal interest rates of Community currencies are consistently within a band as narrow as that of the ERM (i.e. 2,25% or any narrower fluctuation band to be established during Stage two).

Under free capital movements and harmonised taxation of interest income, this condition amounts to full market confidence in the existing parity grid.

iv) The Community as such has already evolved into a true Economic Union. Specifically, all Community policies comply with the principle of economic and social cohesion. Furthermore, the Community budget has taken on any role required for the Economic Union to operate smoothly under strict market principles.

According to this timetable, during 1999 or shortly thereafter the European Council should take stock of progress achieved and asses whether the conditions for passage to Stage three have been met. In assesing progress in the monetary field, the European Council will specifically seek the advice of the European System of Central Banks. If it were to decide for the Community to move into full EMU, the Council would be empowered to establish a special transitional arrangement for any country unable to participate yet in EMU in its final stage.

Madrid, September 25, 1990