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*I will study*  
*M. Amato's paper*  
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EUROPEAN MONETARY CONSTRUCTION: ITALIAN VIEWS

SUMMARY

1. ITALIAN RESPONSE TO BALLADUR'S IDEAS ON STRENGTHENING EUROPEAN MONETARY CONSTRUCTION DESCRIBED BY TREASURY MINISTER AMATO.

DETAIL

2. WHEN I PAID A COURTESY CALL ON AMATO, TREASURY MINISTER, ON 23 FEBRUARY HE SAID THAT, LOOKING TOWARDS 1992 AND THE DECISIONS WHICH WERE NEEDED IN THE PERIOD IMMEDIATELY AHEAD, WE MUST MAKE THE MOST OF THE GERMAN PRESIDENCY. HE HAD JUST SENT A PAPER TO BALLADUR SETTING OUT ITALIAN VIEWS ON THE FRENCH PROPOSALS ON STRENGTHENING EUROPEAN MONETARY CONSTRUCTION. HE WOULD BE SENDING A COPY, IN ENGLISH, TO THE CHANCELLOR OF THE EXCHEQUER WITHIN A FEW DAYS. MEANWHILE HE AGREED TO GIVE ME A COPY WHICH WE WILL PUT IN THE BAG OF 26 FEBRUARY FOR TURNER ECD(I).

3. THE PAPER, REAFFIRMING THE ITALIAN GOVERNMENT'S COMMITMENT TO THE OBJECTIVE OF AN INTEGRATED FINANCIAL AREA IN EUROPE, PROPOSES CONSIDERATION OF 5 MAIN ISSUES:

A) DEVELOPMENT OF A SYSTEM FOR RECYCLING FUNDS TO OFFSET POTENTIALLY DESTABILISING SHORT TERM CAPITAL MOVEMENTS.

B) ALL COUNTRIES SHOULD JOIN THE ERM SO THAT BENEFITS DERIVING FROM COMPLETE MOBILITY OF CAPITAL AND THE BURDENS OF CONSTRAINTS ON EXCHANGE RATE POLICY ARE FAIRLY SHARED.

C) WITHIN THE EMS, ADJUSTMENT BURDENS MUST BE MORE FULLY SHARED BETWEEN SURPLUS AND DEFICIT COUNTRIES.

D) A COMMON POLICY TOWARDS THIRD COUNTRY CURRENCIES TO BE

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SYSTEMATICALLY DEVELOPED ENTAILING USE OF THE ECU AS A REFERENCE AND INTERVENTION CURRENCY.

E) PROGRESS TOWARDS ESTABLISHING A EUROPEAN CENTRAL BANK INVOLVING INCREASING USE OF THE ECU AS A RESERVE CURRENCY AND FOR PRIVATE TRANSACTIONS.

4. AMATO EMPHASISED TO ME THAT ITALY WOULD BE PREPARED TO RENOUNCE ITS BROADER BAND IN THE ERM WHEN, BUT NOT BEFORE, STERLING JOINED. I WENT OVER THE PRACTICAL DIFFICULTIES WHICH STOOD IN THE WAY OF THE POUND ENTERING THE ERM. AMATO SAID HIS PAPER SUGGESTED THAT IF STERLING JOINED THE NORMAL BAND OF FLUCTUATION MIGHT BE ENLARGED SOMEWHAT WHICH HE BELIEVED MIGHT EASE ANY RESIDUAL PROBLEMS ARISING FROM STERLING'S ROLE AS A RESERVE AND PETRO CURRENCY. THE OTHER ASPECT OF ITALIAN THINKING TO WHICH HE DREW MY ATTENTION WAS THE NEED TO FIND A WAY, PERHAPS THROUGH DEVELOPMENT OF A CENTRAL EUROPEAN BANK, TO DILUTE THE DOMINANT ROLE OF THE DEUTSCHMARK. HE SAID HE WOULD BE VERY HAPPY TO DISCUSS ANY OF THESE ISSUES WITH ME IF WE WOULD THIS HELPFUL.

THOMAS

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*Il Ministro del Tesoro*

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N.C.	23 FEB 1988
TO	B/EST
COPIES TO	Mr Peretz
	Sr P Middleton
	Sr G Little
	Sr T Burns

*and BF 24/2*

Rome, 23 February, 1988

Dear Colleague,

the reading of M. Balladur's useful paper on the "European Monetary Construction" has induced me to put in writing my thoughts on a subject which is both fascinating and challenging. May I draw your attention to the attached note, which has to be regarded as a contribution to a needed debate; not only immediate objectives but also long term goals have to find a place in it, if the single market is to succeed in changing the structure of the Community economy, as well as adapting policy-making to the requirement of "real" and financial integration.

With my highest regards

sincerely yours

AMATO  
23/2



(Giuliano Amato)

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Mr Nigel LAWSON  
Chancellor of the Exchequer  
H.M. Treasury  
Great George Street  
London SW1



ON "EUROPEAN MONETARY CONSTRUCTION" (1):

THE ITALIAN POSITION

1. The EMS has achieved important and certainly positive results. However, a number of imperfections and shortcomings undoubtedly still exist within the system and should be addressed in order to make the system work better and correct, as far as possible, those aspects which produce an asymmetry in the distribution of the adjustment burdens.

Indeed, there is a "fundamental" problem in the EMS, which can be attributed to the fact that there is no "engine of growth". Not only is the pivot currency of the system fundamentally undervalued, but the growth of domestic demand in Germany is lower than the average; the result is that that country has structural surpluses also vis à vis the rest of the EEC. These surpluses, both commercial and current, on the one hand induce tension in the exchange system, pushing up the D-mark, particularly when the dollar drops, and, on the other hand, they remove growth potential from the other nations. In the long term, the cohesion of the system could suffer.

It is difficult to think of solving the operative, fundamental and institutional problems raised in the French document, without taking into account that those issues are closely interdependent and without a strategy based on a well delineated critical path. In fact, what must be appropriately evaluated is whether a fixed exchange rate system can coexist with the full liberalisation of capital movements, while economic policies continue in point of fact to be unconstrained. In particular, one must remember that it is not possible for fixed

(1) Note of Minister Balladur to his colleagues, dated January 8, 1988.



exchange rates to be made compatible with the exercise of autonomous monetary policies by individual member countries, in the context of a single market for persons, goods, services and capital.

2. On the two essentially operative issues - the liberalisation of capital and the harmonisation of the conditions for participation in the EMS - the Italian position coincides largely with the French one, although it seems opportune to put forward the following considerations:

a) Liberalisation and internationalisation of the monetary and financial markets

The fact that the process for the creation of one single market is already underway, and the need to adapt the financial and monetary markets to the new requirements which will emerge from unification, have led the governments of a number of member states to approve measures for reducing exchange rate controls. The political commitment of Italy in this direction has been reaffirmed by the recent withdrawal of the measures temporarily adopted in September of last year to defend the lira's exchange rate. However, there continues to be an awareness, on the part of the Italian government, of the risks implicit in this process of integration in the absence of efficient measures to coordinate the economic policies of the member countries, resulting from sudden movements of short term funds with consequent destabilising effects.

A condition necessary for the realisation of the single market in the financial sector is, therefore, that efforts be intensified to promote greater cooperation between the member



countries, with particular reference to their respective economic and monetary policies, and a minimum degree of convergence in the sectors of taxation, supervision and other forms of regulation.

It is also worth considering the possibility, in addition to the coordination of monetary objectives, as well as interest rates changes, of identifying what systemic modifications could be made, so as to avoid possible destabilising effects on the EMS.

The strengthening of the financing mechanisms of intra-marginal interventions, agreed on in Basle and in Nyborg, while being a significant step forward, has not solved all the problems related to closer monetary cooperation. First and foremost, what seems particularly necessary is a reform of the financing mechanisms and the strengthening of the role of FECOM in managing the EMS. In this context, so as to counter the tensions which can derive from capital movements in the short term, not justified by the trend of the basic economic variables, consideration can be given to the creation of a recycling mechanism, through FECOM, which could borrow funds on the market and reallocate them in such a way as to compensate the inflow and outflow of capital among the countries involved.

In any event, and in addition to a possible mechanism of the kind referred to in the previous paragraph, the safeguard clause, foreseen in the project of the EEC directive on the complete liberalisation of capital movements, remains a fundamental point of reference. We believe this "safety net" is indispensable in the transition to the single market: the convergence of economic results can reduce the risk of destabilising capital movements, but it cannot eliminate that risk as long as the EMS has fixed, but adjustable, exchange rates.



b) Homoqenization of the membership conditions of the EMS and the extension of the system to all EEC countries

Parallel to efforts to arrive at the complete integration of the European financial markets, action must be taken to ensure that the conditions of participation of each member country in the European monetary system are homogenous; in this regard, the Italian government believes that a distinction should be made between the EEC nations which are not part of the exchange rate agreements (ERA), or of the EMS, and those, including Italy, who enjoy a particular treatment within the system.

The need to extend the European monetary system to all the nations of the Community, albeit in the complete respect of the accession Treaties, is related to the liberalisation of capital flows, the realisation of the single market, and the consequent need to harmonise monetary policies.

In fact what should be assured is a greater coherence between participation in the benefits deriving from the complete mobility of capital, and the inclusion of the currency in the ECU basket, on the one hand, and the acceptance of the exchange constraint, on the other. In this context, one can note that the nations not adhering to the exchange agreements would gain from the complete liberalisation of the capital market in Europe, without being subject to the restrictions which it places on domestic economic policies. The presence of the currencies of these nations in the ECU basket also has negative repercussions on the ECU's development, since it becomes less attractive as an international reserve instrument and as a financial instrument in operations between private parties.

In the event of full membership of the other EEC nations in



the exchange rate agreements, in particular the entrance of the United Kingdom, one should then take into consideration the possibility, given the persistent, though decreasing, nature of international currency and of "petrol currency" in part held by sterling, of enlarging somewhat the normal band of fluctuation within the EMS, so as to protect the system from additional shocks.

If this hypothesis of greater flexibility of the system were implemented, it would not be incompatible with the final design for fixed exchange rates in the context of the construction of a European central bank, as it could be a step towards the harmonisation of conditions necessary to achieve that objective.

However, apart from the considerations outlined earlier, a system extended to the EEC countries which are not members of the exchange rate agreements, or of the EMS, could encounter increased difficulty. Hence, greater emphasis needs to be placed, at the Community level, on the coordination of economic policies. In this respect, procedures would perforce have to include ways of identifying divergent countries - whatever the direction of the imbalance - from whom to require a greater effort of adjustment.

In a context in which the said conditions and objectives were achieved, there would be no reason for maintaining differential treatments within the EMS, including the lira's wide band.

3. Other themes require careful consideration of fundamental and institutional aspects. They concern:

- c) The internal functioning of the system and the asymmetry of the burdens it involves for different countries



As we have already remarked, the Italian authorities agree with the French on the fact that the distribution mechanism of the EMS intervention obligations on the exchange market place a greater burden on the country whose currency is less sought after in international markets, even when the cause of an imbalance is to be attributed to the "less growth-oriented" policy of the nation whose currency is in greater demand. This asymmetry of obligations implies the acceptance on the part of other member countries of equally restrictive monetary policies if they wish to respect the exchange rate constraint. This notably is a point which could explain the reluctance of Great Britain to become a member of the EMS.

The asymmetry which derives from the role of the "dominating" currency, and the deflationary bias which results therefrom, means that the system itself is particularly vulnerable to external shocks, which can lead to considerable appreciation of strong currencies. Moreover, this makes the hold of the band of weaker currencies and the process of structural adjustment in the issuing countries comparatively more difficult. These in fact may be driven to devalue because of the greater burden they are called to bear to defend exchange rate parity. Thus they acquire margins of competitiveness in the short term which, however, are subsequently eroded by the higher imported inflation and the slowing down of the processes of internal adjustment.

In the present institutional context, not even a greater symmetry of the system, obtained, for example, by imposing on the nation which issues the more sought after currency to intervene on the markets to help the weaker currencies in the EMS, seems in itself desirable even if it were politically possible. In its



extreme form, it would lead the system to defend the exchange rate relations within the agreed band, without being able to pursue a monetary rule and, therefore, the stability of the internal value of the currency. Without a common and homogenous attitude towards inflation, the system would become biased towards monetary instability.

In the final analysis, the need referred to at the beginning for an "engine for growth" which would favour real adjustment remains. An effective solution of the asymmetry issue implies an institutional transformation, capable of leading to the common identification of the objectives of economic policy, which include the stability of prices, but also growth.

d) The need to draw up common policies vis à vis the currencies of third countries

With the presence of the four major EEC nations in the Group of the 7 most industrialised nations, the issue of a common policy vis à vis the other two world currencies, the dollar and the yen, has found a forum in which a joint evaluation of the correspondence of the exchange rate trends or levels with the requirements of international adjustment can be made. If a G-3 were to enucleate itself from the G-7, a problem of coordination, not resulting in the acceptance of the decisions of the authority issuing the strongest currency, would again present itself. In this case as well, the most efficient, albeit not the easiest, solution would be to aim decidedly for a European central bank. In the meantime, an increasing use of ECU as a reference or intervention currency could be of help in determining a common policy vis à vis third currencies.



e) The European central bank

Of all the issues taken into consideration, the problem related to the insufficient degree of convergence of economic results, due to the lack of policy coordination between the EEC countries, is a fundamental one. This is to be attributed to the lack of harmonisation of the objectives of individual national governments on employment, inflation and economic growth. Thus, it is necessary to identify ways to help to overcome possible conflicts between the objectives.

The creation of institutional frameworks of reference, capable of expressing objectives common to the whole of the Community, undoubtedly would be a step in this direction. In particular, the creation of a European central bank able to propose and implement a common monetary policy in compliance with the joint objectives of the Community, would considerably simplify coordination in the monetary sector, and also favour the convergence of the fiscal and structural policies of each nation.

To the de facto reduction in the autonomy of monetary policies, which the "dominating" currency exercises through the exchange rate constraint, is undoubtedly to be preferred an agreed loss of autonomy, through the creation of a European central bank, which would guarantee adequate consideration to national objectives in the context of EEC objectives.

Clearly a process for the creation of an institution of this kind can only be a gradual one and must be considered in a process aimed to realise more general objectives, related to the strengthening of Community structures and the integration between member nations.

The full implementation of a single market necessarily implies fixed exchange rates between the member countries of the



Community and a high degree of coordination of monetary policies; as the common central bank becomes the most efficient instrument for ensuring both of them, logic would require its institution to be brought closer rather than postponed.

4. In conclusion, the Italian government, in confirming its total adhesion to the objective of an integrated financial area in Europe, believes that careful consideration of the following problems is necessary:

- (i) complete capital liberalisation must be accompanied by the preparation of an appropriate mechanism for the recycling of funds, which makes it possible to offset eventual destabilising short term capital movements, and, at least in the transition to the single market, by the introduction of a new safeguard clause, as the one foreseen in the EEC project of directive, (cfr. par. 2, point a);
- (ii) membership conditions of the EMS must be made homogenous for all member countries, who must also be assured that there is complete correspondence between the benefits which derive from participation in the system and from monetary and currency liberalisation, and the constraint implicit in the exchange rate agreements, (cfr. par. 2, point b);
- (iii) within the system, there must be a greater symmetry in the distribution of adjustment burdens between countries in surplus and those in deficit; this is to be sought both at the monetary level (exchange market



interventions, changes in interest rates, coordination of monetary objectives), and at the "real" level with equal responsibility to correct external imbalances, while awaiting an institutional transformation capable of eliminating the imbalances between the countries of the Community, (cfr. par. 1, par. 2, point a, and par. 3, point c);

(iv) a common policy vis à vis the currencies of third nations to be realised by systematic consultative procedures and favouring the use of the ECU as a reference and intervention currency, (cfr. par. 3, point d);

(v) the institutional phase of the EMS must be set off in the near future; in the process of arriving at a European central bank, (cfr. par. 3, point e), concrete steps must be identified, as of now, for strengthening monetary coordination, for attributing to FECOM specific functions which increase its autonomy, and for promoting the role of the ECU as an instrument of official reserve and as a financial instrument in operations between private parties, (cfr. par. 2, point b).