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**HER MAJESTY'S TREASURY**

**COORDINATING GROUP**

**ON ECONOMIC AND MONETARY UNION**

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I attach the final version of the Group's report entitled "Next Steps on EMU: A Report to Ministers".

Wilf White

**A E W WHITE**
**Secretary**

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# NEXT STEPS ON EMU: A REPORT TO MINISTERS

## I INTRODUCTION

1.1. This report, prepared by officials from the Treasury, Cabinet Office, FCO, UKRep Brussels and the Bank of England, is intended to provide Ministers with a basis for deciding HMG's strategy and tactics both in the approach to and during the forthcoming Inter-Governmental Conference (IGC) on economic and monetary union (EMU).

1.2. The UK Government's position on the IGC is that we consider its calling to have been premature but we will play a full and constructive part in its work.

### <u>The IGC, Treaty change and EMU</u>

1.3. In considering the issues raised by the Strasbourg decision to call an IGC to "prepare an amendment to the Treaty with a view to the final stages of EMU", it is important to distinguish between:

i) the process of preparing and negotiating treaty provisions in an IGC; and the subsequent ratification and entry into force of these provisions;

ii) actual movement towards EMU, beginning with removal of Italian exchange controls this spring, followed by the 1 July start of Stage 1; and

iii) developments thereafter which, on the Delors Report model, would consist of a move, after an undetermined period, to a Stage 2 and, after a further undetermined period, to a Stage 3.

The IGC process is likely to be relatively rapid, but that does not mean that progress towards EMU need be. In practice it will not be, if EMU is to be attained at the same pace throughout the

Community, ie at the pace that, for example, the Portuguese and Greeks can manage.

1.4. Indeed, in the light of the experience of the Werner Report - which set deadlines which proved nugatory - the Delors report itself came down firmly against any attempt to set fixed dates for the moves from Stage 1 to Stage 2 and from Stage 2 to Stage 3. No-one has so far challenged that, and it is much in our interest that it should be sustained throughout the IGC sequence.

1.5. External events, eg the upheavals in Eastern Europe and above all the move to monetary union in Germany (GMU), will affect the pace of these processes quite differently. Because GMU may lead to some disturbance, and possibly realignments, in the ERM, actual progress towards EMU may be slowed by these external developments, thus giving the dynamic effects of the Single Market more time to work through before a move to Stage 2 can be contemplated. But the treaty drafting process is, perversely, more likely to be accelerated, as the large majority of member states keen on early progress become the more determined to get on with the IGC (and very possibly to bring it to a reasonably rapid conclusion) in order to demonstrate that, at least on paper, development of the Community is continuing. Our report makes no judgement on these various external forces. But we judge that it would be wrong to assume at this stage that the task ahead of us in an IGC will be made easier by the events in Eastern and Central Europe.

1.6. Proceedings in the IGC will also be influenced by the state of the European Monetary System: an ERM in disarray may cast doubt on the whole enterprise of EMU; yet that very disarray may suggest to some member states a reason for pressing ahead all the faster. The UK's current attitude to ERM membership will influence the attitude of other Member States to our negotiating position in the IGC.

1.7. The UK paper on "An Evolutionary Approach to Economic and Monetary Union" published last November has proved a valuable contribution to the debate on EMU. Its emphasis on an approach which minimises inflationary risk, which devises practical means for moving towards EMU and which works with the grain of the market was welcomed. But the paper failed to command support as a credible alternative to the Delors' definition of full monetary union, partly because of what was seen as the UK's unwillingness to accept the ultimate goal of EMU, and partly because the paper was perceived as giving primacy to the Bundesbank and this was regarded as politically unacceptable. Scepticism has also been expressed about whether the EMS could, even under our evolutionary process, evolve into one of fixed exchange rates, without some institutional underpinning.

1.8. The other 11 Member States appear likely to insist, with varying degrees of enthusiasm, that a new Treaty should enshrine both the Delors definition of EMU - which would include the eventual irrevocable locking of exchange rate parities and perhaps a single currency - and the creation of a new institution which would underpin the process towards and the eventual management of full EMU. Some in the Community, probably the FRG, will argue for a long Stage 1 and an amending Treaty which clearly specifies the conditions for entering the later stages, a short Stage 2 (or perhaps none at all) and a detailed specification of both the objectives of full (Stage 3) EMU and of the institutional mechanics for implementing it, foremost among which will be a European System of Central Banks (ESCB) which will, to the extent possible, mirror the constitution of the Bundesbank. A few, possibly the French, may argue for a long Stage 2 and probably a detailed specification of Stage 3 as well. (Further information on member states' current views is given in Chapter IV).

<u>The form and general content of an amending Treaty</u>

1.9. It is too early to judge the precise <u>form</u> of an amending Treaty for which there might be majority support in an IGC. We have identified four possible options, but they should, on past experience, be regarded at this early stage in the negotiating process more as a spectrum than as clear cut models:

i) **A new Treaty confined only to some interim "Stage 2" arrangements,** merely hinting at further developments beyond that on the route towards EMU, and leaving detailed specification of "Stage 3" institutions for a further Treaty.

ii) **A Treaty mainly concerned with interim institutional arrangements,** but also defining EMU more specifically as a target; but again leaving detailed specification for "Stage 3" institutions for a further Treaty.

Both these options would require subsequent further Treaty changes to implement the final stage. On the face of it, this seems a sensible and pragmatic approach: it allows time to pass, and the changes in the EC and its markets to take place, before the Community will be ready to define and to take the final step to monetary union. But it is clear that most other member states want to go beyond this. Option (i), in particular, looks unnegotiable. Option (ii) looks more credible, particularly if supported by proposals for institutional changes as part of Stage 2 (see chapter II of this paper). But our present assessment is that at the end of the day it would probably not achieve the necessary consensus because the other member states are keen to establish the future path of the Community. The following two possible options seem more likely to get wide support:

iii) **A Treaty giving a full definition of EMU, and the institutions necessary for its final stage** (together with a transitional stage if agreed); but then allowing an "opting in" mechanism for member states, with different member states allowed to join in the new Stage 3 arrangements at their own pace. This may be the Commission's favoured option.

iv) **A comprehensive Treaty,** which similarly sets out the final stage and its institutions in detail; but which specifies stiff conditions that would have to be met before all member states moved together to full EMU. The Germans may favour an approach like this.

The Delors report (paragraph 44) envisaged that some member states might not participate in all aspects of EMU at the outset and that this would be acceptable provided their influence on the management of the system reflected their degree of participation. Accordingly option (iv) might well include an "opting out" procedure permitting individual member states to delay their participation for justifiable reasons. If so, this option would be closer to, though still distinct from, option (iii).

1.10. We thus seem most likely to be faced with an amending Treaty which takes the form of (iii) or (iv), or some combination of the two. As for the detailed content of an amending Treaty, the models above could conceivably encompass arrangements proposed in the Delors Report or different ones.

1.11. If option (iv) were chosen, the conditions for proceeding from one stage to the next would need to be determined. Such "firebreaks" could be institutional and/or functional. So far as institutional "firebreaks" are concerned, the Delors report (paragraph 63) refers to the moves from Stage 1 to Stage 2 and from Stage 2 to Stage 3 requiring "an appraisal of the situation and a decision by the European Council". We might at least wish to insist that each move should require a unanimous Council decision. (It would of course be possible for any member state to declare that it would not participate on such a decision without the agreement of its Parliament.). A functional firebreak would involve setting out objective conditions, eg levels of achieved economic convergence, or intra-ERM exchange rate stability, which would need to be fulfilled before the moves from Stages 1 to 2 and/or 2 to 3. It is difficult to envisage how either type of firebreak could be a feature of option (iii).

1.12. The choice between options (iii) and (iv), and the nature of the firebreaks if option (iv) were chosen, would be likely to depend on other member states' assessment of the attitude of the UK in particular. Those keen to proceed so full EMU would be reluctant to agree to a mechanism allowing one member state to thwart the wish of the others if they believed that it would in practice be so used.

1.13. Clearly, if Ministers wish to attempt to shape the product of an IGC in a direction that we could support, they will need to have devised a coherent strategy and the tactics to implement it. The forming of alliances, both before and during the IGC, will be essential if we are to achieve any objective which we set ourselves. This report, however, focuses on the key policy issues which need to be considered before Ministers decide questions of tactics and presentation.

## The structure of this Report

1.14. The remainder of our report is divided into the following chapters:

II monetary aspects of EMU, including questions concerning the definition of monetary union and possible institutional arrangements both for Stage 2 and Stage 3;

III the implications of economic union - the question of binding budgetary rules in particular;

IV a summary of the views of other member states on EMU and the IGC, and the approaches they are likely to adopt; and

V a list of the main issues arising which Ministers may want to discuss.

1.15. A list of annexes which are available on request is given at the end of the report.

## II MONETARY ASPECTS OF EMU

2.1. In the IGC, and the discussions leading up to it, we are going to have to take a view on:

i) what definition of Monetary Union we can accept.

ii) what kind of institutions in the final stage would be acceptable.

iii) what, if any, interim steps we could support (as useful in their own right, whether or not they led to further development).

2.2. We suggest that our basic position for the objectives of monetary union should be those set out in our November 1989 paper: price and currency stability; lower costs of financial transactions, especially across borders; and equal access to financial instruments and services throughout the Community. We have shown how the market forces at work during Stage 1 will go a long way to meet these objectives. It is important to ensure that any step beyond Stage 1 does not compromise them; and in particular that it does not undermine the objective of price stability.

2.3. This chapter considers (A) the definition of full monetary union, and (B) possible institutional developments.

### A. Definition of full Monetary Union

2.4. Although in principle the definition of a monetary union <u>might</u> cover an area within which several currencies freely circulate, in practice monetary union in the Community has always been defined as either:

i) irrevocably fixed parities between national currencies; or

ii) a single Community currency.

2.5. The definition in the Delors Report (paragraph 22), taken from the 1970 Werner Report, sets out "three necessary conditions" for a monetary union:

- the assurance of total and irreversible convertibility of currencies:

- the complete liberalisation of capital transactions and full integration of banking and other financial markets; and

- the elimination of margins of fluctuation and the irrevocable locking of exchange rate parities.

The Werner Report concluded that: "... the single most important condition for a monetary union would, however, be fulfilled only when the decisive step was taken to lock exchange rates irrevocably ... The replacement of national currencies by a single currency should ... take place as soon as possible after the locking of parities."

2.6. We avoided accepting the Werner/Delors definition in the UK paper through the words in the penultimate sentence "........the system could evolve into one of fixed exchange rates." But we do not believe we can realistically hope to challenge in an IGC the Werner/Delors definition, which is the one always used by economists and monetary experts. Indeed, to attempt to do so could discredit our case generally.

2.7. So we think that a large majority of member states, indeed probably all the other 11, will be ready to see monetary union defined in a Treaty in either one or a combination of the two alternatives in paragraph 2.4. There will be a strong wish in certain countries for some sort of commitment to an eventual single currency. Either alternative would cause us difficulty, since both require the operation of a common monetary policy, throughout the Community; and both therefore would need some form of Community central monetary decision-taking mechanism.

Acceptance of either alternative definition of monetary union, in paragraph 2.4 above would not prejudice our negotiating position on the procedures for moving towards a monetary union: in any case, no one is pressing for a timetable to be laid down in a Treaty. Though the UK has already subscribed to political texts envisaging the progressive implementation of EMU, we are not committed either to a timetable or to any particular institutional framework. But our acceptance of a definition of monetary union as an objective of the EC would implicitly rule out any opposition in principle to Treaty texts designed to achieve its progressive implementation.

*Irrevocable locking of parities*

2.8. Of the two options in paragraph 2.4, irrevocable locking of parities looks more like a natural progression from a Stage 1 ERM system of fixed but adjustable parities: indeed, we accepted in the UK paper last November that this was a point that might eventually be reached. But irrevocable locking:-

i) would involve some central procedures (and almost certainly a central institution) for making decisions about the general level of (short-term) interest rates in the Community; and

ii) could well be unstable, likely to lead fairly quickly - assuming member states really are committed to irrevocable locking - to a single currency.

2.9. The reasons for the conclusions at (ii) are as follows. So long as separate currencies remain, market participants may not believe that parity locking really is irrevocable. The system would be likely to go through periods of calm, with more or less identical short-term interest rates in all countries, but with intermittent bouts of market pressure involving widely differing interest rates, and pressure on some central banks to exchange their currency for others. To demonstrate that locking was irrevocable, central banks would have to be ready to exchange their currency for the others without limit, at the fixed parity.

There would thus be no national control of money supply and decisions on the general level of interest rates would have to be taken jointly. To reduce market turbulence there would be great pressure to do more to reassure the market that locking was irreversible. The two obvious steps would be to establish a more powerful central monetary institution; and to move to a single currency. So we suspect that any attempt to operate a system of irrevocably fixed exchange rates could quickly lead to a move to a single currency. It might therefore be difficult for us to argue that we were committed to irrevocably locked currencies, but as a matter of principle could not commit ourselves to a single currency.

2.10. It should also be noted that, when other member states envisage irrevocably fixed parities as a possible definition of EMU, they are not thinking of a procedure under which separate national central banks, and separate national monetary policies, would be maintained. They probably have in mind the version set out in the Delors Report under which there would be a single EC monetary authority and the separate national currencies would only continue to exist for political and presentational reasons.

*Interim Stages*

2.11. This analysis is predicated on "full" monetary union. Before then, even in an intermediate stage during which exchange rates in the ERM had become much more stable, the possibility of parity changes would leave member states with a degree of freedom of action in setting monetary policy. One way in which an IGC might agree the system should develop is that some countries would opt to go for full union - irrevocable locking with no margin of fluctuation - earlier than others. Those countries that chose to travel outside would then retain freedom to set national monetary policies; those that had opted for full union would not. We would need to consider the advantages and disadvantages of this sort of arrangement.

## B. Institutional Developments

2.12. Most of the discussion so far in the Community has been about institutions needed after full monetary union ie in Stage 3. At an IGC we can expect the Commission and other member states to table various schemes, in legislative form, for such institutions, and we need to be ready to respond. Member States' views on Stage 3 will inevitably shape their views on the transitional phase. The next section of the paper therefore discusses these issues.

2.13. But there is also a further issue : are there any interim institutional changes, useful in their own right, that we could support for developments before Stage 3? Insufficient thought has been given to this aspect in the Community so far. We discuss below (paragraphs 2.34-2.41) some possible practical initiatives.

**Institutions after full monetary union**

2.14. Before the final stage of monetary union, member states would be able to continue operating their own monetary policies, with decisions constrained by the exchange rate commitment against other ERM currencies - the tighter the commitment, the narrower the constraint. The UK paper showed how this, combined with peer pressure and collective surveillance, should lead to low inflation. But as noted above, once the move to irrevocable fixing had been taken, there would have to be machinery for taking decisions about interest rates at Community level. Market pressures would require the creation of a European Central Monetary Institution (ECMI); and, probably, a single currency. At this stage it would become necessary to devise institutional arrangements, to replace the market forces operating in Stage 1 so as to continue to build in a similar bias towards price stability.

2.15. Four key issues are beginning to emerge in discussions of Stage 3 institutions :

i) **The fundamental objective** of a European Central Monetary Institution (ECMI).

ii) **The degree of independence, of such an institution;**

iii) **Democratic** (or as we might prefer to put it **political) accountability.** What does this mean : control by national governments through the Council of Ministers, or a system where the ECMI renders account to national governments and/or parliaments, and to the European Parliament?

iv) **Policy responsibilities of the ECMI** - presumably it would set interest rates; but where would responsibility for (external) exchange rate policy lie? And what about responsibility for banking supervision?

Current discussions in the Monetary Committee are also focusing on issues concerning the structure of an ECMI (eg one Board of Separate superintending and executive Boards) and voting rights of Board members. This report does not consider these detailed, though important, issues.

*(i) Fundamental objective*

2.16. We assume that the Treaty itself should specify that the objective of the ECMI would be price stability and that any other terms of reference should be framed in such a way as not to detract from this fundamental aim.

*(ii) Independence and control*

2.17. The realistic choice is between an ECMI that has a substantial measure of independence, and an ECMI controlled by the Council of Ministers. There would be constant pressure from one member state or another to reduce interest rates and accommodate price increases. We have argued in the UK paper that decisions within an independent bank might still be liable to compromise between national interests (thus leading to decisions which converge on the average rather than the best inflation performance). Decisions in the Council of Ministers taken by majority vote would be even more liable to compromise and avoidance of tough but necessary action. All this suggests that

Finance Ministers as well as Central Bank Governors, as a matter of international economic relations. Indeed probably all other member states would accept that the international exchange rate regime (to take an example from the past, the operation of the Bretton Woods system) is a matter for governments, not central banks.

2.25. There are some further supporting arguments about where responsibility for holding reserves should lie :

i) owning foreign exchange reserves entails financial risk. Even where reserves are owned by central banks, these risks are sometimes underwritten by governments. But if EC governments underwrote the ECMI's reserves they would want a say in their use and investment. Moreover currently national reserves belong in most countries to governments rather than central banks, and have a very uneven distribution between EC countries;

ii) intervention has to be financed, and preferably financed in a non-monetary way. If the Community's gold and dollar reserves were held by the ECMI it might need to borrow from member governments if the reserves were increased by intervention.

2.26. This suggests a case for a different approach to the Delors Report proposal, under which the proposed ECMI is responsible for the "formulation and implementation" of exchange rate policy, with official reserves pooled and managed by it. The alternative arrangements might be on the following lines :

i) exchange rate policy against the dollar and yen to be a responsibility of ECOFIN, after consulting the Central Bank Governors Committee/ECMI;

ii) ECOFIN to nominate one of their number - not necessarily the German Finance Minister as it would be at present - to attend G3 meetings (EC, USA and Japan) if G7 did not continue, together with the Chairman of the ECMI;

iii) guidelines for intervention policy against the dollar and yen to be set by agreement in ECOFIN;

iv) ownership of reserves to remain with national governments/central banks as at present. But intervention against dollar and yen to be carried out, on an agency basis, by ECMI - with reserves contributed and withdrawn in tranches, as necessary, by member states.

2.27. There would inevitably be a tension in such arrangements between Governments and the ECMI : but the same tension already exists on exchange rate policy in many member states - and indeed other countries, such as the US.

2.28. There are signs that the French may favour an approach of this kind, though it is very different from that favoured by the Bundesbank. It could have implications for intermediate institutional developments (see paragraph 2.40 below).

*Banking Supervision*

2.29. The Delors Report suggests (paragraph 32) that, in addition to its monetary policy functions, the ESCB "would participate in the coordination of banking supervision policies of the supervisory authorities". Banking supervision is, of course, an area where there is already some Community competence: for example, the recently adopted legislation to create a single market in banking imposed minimum standards of capital adequacy on banks in the Community. Within Member States, responsibility for carrying out supervision normally lies with the Central Bank but there are some notable exceptions (Belgium, Denmark and Germany). Arrangements already exist (for example the Banking Advisory Committee (BAC) and the Contact Group) whereby national supervisory experts discuss matters of common interest, advise the Commission, and act as regulatory committee for the purposes of introducing delegated Community legislation.

2.30. Since EMU will not create any fundamentally different banking supervisory problems, there is no particularly strong reason why these arrangement should be changed. On the other hand, the sound functioning of the banking system is a matter of importance to Central Banks and, as part of Stage 1 of EMU, the Committee of EC Governors is already strengthening its arrangements for discussing and dealing with those supervisory matters of common interest to member Central Banks; where the Central Bank does not have legal responsibility for banking supervision, provision is being made for the non-Central Bank supervisory authority to be represented. It would be reasonable for such arrangements to continue in the later stages of EMU and thus sensible for any ECMI which was set up to be consulted on supervisory matters. The ECMI would be likely to want to concentrate on matters of principle, leaving more technical and detailed considerations to the BAC and the Contact Group, ie to national supervisory authorities acting collectively.

*"Gold Standard" Options*

2.31. It is worth pausing to consider whether there is any alternative approach that requires less centralisation of monetary policy in a "full" monetary union. There is one approach, in theory, that would avoid the creation of a new central institution with significant powers : if separate national currencies (or indeed a single Community currency), were linked to some external standard, preferably one that retained its real value. There would be loss of sovereignty in the sense that national central banks would lose power of discretion, but no transfer of sovereignty from national to Community level.

2.32. Possibilities include a link to gold, or some basket of commodities. A modern variant would be a link to a centrally defined and issued index-linked currency, say an indexed ecu.

2.33. The approach suffers two difficulties. First there is no evidence of any such system being made to work in modern times (and even the gold standard did not always work in practice as the text books said it should). But this is not a fatal drawback, since we have no evidence of the successful achievement of a monetary union of the kind proposed by Delors either. Second, and more important, we do not think it would be negotiable with our Community partners. To float it at this juncture would be regarded as a wrecking tactic : and we doubt whether it would succeed.

**Interim institutional steps in Stage 2**

2.34. As noted above, we will also need to decide our attitude to proposals for Treaty change to bring about interim institutional development, before the final stage of monetary union (if it ever happens). The German position is to resist such developments, and to argue for a long Stage 1 (we agree) but a short Stage 2 or none at all. The French on the other hand seem ready to contemplate a form of Stage 2 which incorporates the creation of some new institution, though following a much briefer Stage 1 than the Germans would favour.

2.35. Ministers will wish to consider whether there is a case for supporting interim institutional developments. The more positive we can be in this respect, the greater the weight that some other member states may be willing to give to our views on the final stage. But there can be no certainty that this tactic would succeed, in view of the firm commitment of most other member states to a clear definition of the final stage: indeed the probability is that it would not. Even so in any event there are some institutional developments that might make sense in their own right whether or not the Community ever moves to "full" monetary union. Just as the UK paper suggested an evolutionary approach towards EMU, so it is possible to envisage an evolution of the present institutional structure. This could have the incidental advantage of removing some functions at present carried out by the Commission to a body more closely associated with the Council and Central Bank Governors' Committee.

2.36. The proposal we could make is that as experience is gained with Stage 1, a new Community institution should be created. We have given it the working title of European Monetary Fund (EMF).

This would have a range of functions, some new and some already carried out by others.

*Three possible functions for an EMF*

2.37. To take the possible new functions first, there is one concrete and practical step, but which could have considerable appeal as a natural development of our evolutionary approach : the creation of a **currency board**, to issue ecu bank notes (and possibly coin) for general circulation. The board would do this backing the notes and coin, precisely, with the required basket of base money in the 12 national currencies. It would provide ecu notes on demand, in exchange for Community currencies. But when, for example, a bank went to it with drachma and asked for ecu notes, it would have to exchange the excess drachma - other than those needed to back the ecu issued - at the prevailing market rate for the base money in the other 11 currencies it needed as backing.

2.38. We could expect German opposition to such a proposal: the Bundesbank has always been opposed to the use of parallel currencies, in general and the ecu in particular. Nevertheless, there would be several advantages:

i) its symbolic appeal is that it would bring into being an ecu notes (and possibly coin) circulation comparatively quickly. There seems no other mechanism which is likely to stimulate retail usage of ecu currency on the same scale in the near future (though views differ widely about the likely scale of demand for ecu notes);

ii) by contagion, it might also add to the appeal and usage of the private ecu more generally, deposits for example;

iii) it would also break down some of the remaining barriers to the free circulation of currencies within the Community, so speeding up the process of currency competition. Over time, the proportion of ecu notes and coin in circulation should increase and the proportion of national notes and coin reduce, to some extent.

2.39. There seems no reason why a Currency Board issuing ecu notes would be incompatible with the UK's evolutionary approach to monetary union. Indeed, in some respects it would be neatly complementary. The evolutionary approach argues that in the environment of Stage 1, there will be factors pushing monetary policies towards low inflation policies. Countries which tried to pursue inflationary policies would be punished by suffering damaging devaluations of their currencies.

2.40. The same or another institution could take on a responsibility for co-ordinating intervention against third currencies. The Delors Report included a minority proposal for pooling national reserves in Stage 2. Co-ordination can however take place without reserve pooling, and would logically make sense after all member countries have joined the ERM. The precise function might involve:

i) no pooling or change of ownership of reserves; but

ii) voluntary (ie unanimous) agreement that all Community intervention against the dollar and yen would be channelled through a single agency that would draw and repay tranches of dollars, yen and national currencies as necessary from member states; subject to

iii) intervention guidelines agreed by the Council (after consulting the Central Bank Governors' Committee).

2.41. Finally, an EMF might take over a range of existing functions performed by the Commission and others. These include:

i) managing the ERM : its short-term financing facilities and realignments (work currently largely done by the Monetary Committee, its Secretariat, and central banks);

ii) managing the ecu : both the official ecu, and development of the private ecu including, perhaps, its clearing system (tasks currently carried out by the EMCF, the Commission, and the BIS);

iii) managing Community financing facilities. This would include recommending conditions for Community loans to member states, and monitoring performance - a function largely carried out at present by the Commission;

iv) providing a Secretariat, and research and development facility, for ECOFIN, Central Bank Governors' Committee, and Monetary Committee.

2.42. If Ministers wished to pursue a proposal of this sort, careful thought would have to be given to its presentation. Other member states would be unlikely to take it seriously if they considered that it was being put forward merely as a diversionary or wrecking tactic.

## III ECONOMIC ASPECTS OF EMU

3.1. The Delors Report (paragraph 25) defined economic union as consisting of four essential elements:

- a single market within which persons, goods, services and capital can move freely;
- competition policy and other measures aimed at strengthening market mechanisms;
- common policies aimed at structural changes and regional development; and
- macro-economic policy coordination, including binding rules for budgetary policies.

3.2. While accepting this broad definition of economic union, the UK paper expressed strong reservations about the Delors Report's proposals in the fourth area, macro-economic policy coordination, particularly in relation to the recommendations for binding budgetary policy rules.

3.3. Before discussing the latter, however, it is worth noting that the Delors Committee envisaged that economic policy coordination would go beyond budgetary policy, and that the Community would:

> "....set a medium-term framework for key economic objectives aimed at achieving stable growth, with a follow-up procedure for monitoring performances and intervening when significant deviations occurred."

3.4. The principle of subsidiarity, however, implies that macro-economic policies and objectives, with the exception (in Stage 3 as defined in the Delors Report) of monetary policy and price stability, are properly the preserve of national governments. While the surveillance process will inevitably involve discussions of macro-economic developments and policies, it will be essential to avoid any extensions of Community competence in this area. This means avoiding any suggestion of centralised decisions on policies or objectives.

Budgetary policy rules

3.5. The Delors Report (paragraph 30) advocated:

> "In the budgetary field, binding rules are required that would: firstly, impose effective upper limits on budget deficits of individual member countries of the Community, although in setting these limits the situation of each member country might have to be taken into consideration; secondly, exclude access to direct central bank credit and other forms of monetary financing while, however, permitting open market operating in government securities; thirdly, limit recourse to external borrowing in non-Community currencies. Moreover, the arrangements in the budgetary field should enable the Community to conduct a coherent mix of fiscal and monetary policies."

3.6. In Stage 2, the Report envisaged that such rules would be precisely formulated but would not yet be binding. In Stage 3 they would become binding.

3.7. The UK paper explained that we could not accept the first of the binding rules proposed by the Delors Committee in the passage quoted above. We could accept the third rule to the extent that it precluded monetary financing; but the Delors Report suggested that it might go further than this. And we have reservations about the use of the word "conduct" in the final sentence of the passage quoted above, which seemed to imply a system of centralised decision-making. We also expressed a general reservation about binding EC rules to the extent that "they infringe the principle of subsidiarity and could lead to acute political difficulties within member states". The paper did, however, accept that there was a case for Community rules in the following areas:

i) an explicit understanding that there will be no monetary financing of budget deficits; and

ii) agreements that the Community will not bail out governments which run excessive deficits.

3.8. We also now believe that there is a case for:

iii) imposing in the context of Community mechanisms for lending to a member state, a legally binding budgetary commitment upon that member state as a condition of the loan, if it chose to take up that loan;

and we would be prepared to concede:

iv) establishing, in order to underline the undesirability of excessive budget deficits, binding Community procedures on member states for the surveillance of national budgetary policies - what would be binding would be the procedures and <u>not</u> the outcome of the surveillance exercise.

(These four "binding rules" have already been endorsed by the Chancellor and the Prime Minister: Private Secretary letters of 12 February and 13 February.)

i) **<u>Prohibition of monetary financing</u>**

3.9. Rules prohibiting monetary financing are envisaged under both the Delors and UK approaches. These rules could be imposed under existing Community legislation - for example, by amending the Convergence Decision or by adopting directives to give effect to a revised Decision. But there seems no reason for the UK to oppose inclusion of such a provision in general terms in the Treaty, even if it is not strictly necessary. Details could be fleshed out by the competent bodies and incorporated in subordinate legislation.

ii) **Prohibition of "bail outs" and Community assistance**

3.10. We have proposed a no bail out rule in the UK paper. That is, there should be no Community arrangements for providing Member States with budgetary support, either from other Member States or, more important, from the Community budget itself. The prospect of such assistance would blunt the operation of market forces on budgetary policy. If the capital markets assumed that Member States or the Community stood behind each other's debts, the presumption of the ultimate threat of default would be removed. This could encourage borrowing by a Member State which is excessive or underpriced according to normal market criteria.

3.11. While these arguments command general support in Community Finance Ministries, many argue that whatever statements the Community might make about no bailing out, the markets would not believe that they would be honoured in the last resort. There is, of course, no way of proving or disproving such an assertion. But a statement in as firm as possible terms enshrined in a treaty would clearly help to persuade markets. There is also a role for Community surveillance procedures in such persuasion (see paragraphs 3.17-3.21 below).

iii) **Attaching conditions to loans to member states**

3.12. The case for the no bailing out approach is further complicated by the arrangements for the Community to provide mutual balance of payments support which already exist under the Treaty and which are currently in use in the case of Greece. Their complete abolition is almost certainly non-negotiable.

3.13. We believe that, if such a Community facility is to continue to exist, steps must be taken to ensure that loans are made only on very stringent conditions including, in the context of budgetary policy, requirements that loans are granted only on condition that the Member State concerned agrees to binding restraints on its fiscal policy designed to ensure that necessary adjustments are made. Loans should also be limited in size and be granted for a relatively short term so that the mandatory budgetary restraints can be made effective. There would be a case for enshrining these rules, perhaps in some detail, in a new Treaty and Council Decision.

3.14. The availability of Community assistance on these terms and on this sort of scale would probably not undermine the operation of market forces to any significant degree. The scale of finance would be too small to prevent bankruptcy in extreme circumstances. Making it conditional on a stringent adjustment programme could even augment the operation of market forces rather than retard them, since countries facing budgetary difficulties would have a clear incentive to bring forward the adjustment process and thereby avoid a stringent Community-enforced adjustment.

3.15. For the system of conditional loans described above to operate effectively, it would be essential that the decision to grant such loans and the monitoring of performance against conditionality were not subject to political direction from the Commission and the Council of Ministers. The success of the IMF has in large part been due to the insulation of its operations from direct political control. There can be little confidence that a Community loan mechanism would be operated with sufficient rigour if it was in the hands of the Commission and the Council. Experience with the current Greek loan - when the Community provided far too much to Greece against criteria that were thereafter badly missed with no penalties being incurred by the recipient - fully bears out this gloomy conclusion.

3.16. In the light of all this it would seem desirable for proposals to grant Community assistance, formulation of the conditions under which it is made available, and the process of monitoring compliance with the agreed conditions, to be undertaken at arm's length from the political process - ie from the Council and the Commission. It might be a role which the proposed European Monetary Fund (EMF), described in paragraphs 2.34-2.40 above, could undertake.

iv) Enhanced arrangements for Community surveillance

3.17. There will be those in the Community who will argue that stipulation against monetary financing, rules against bailing out and strong conditionality on Community support mechanisms, even if they all have the backing of an explicit treaty provision, will provide an insufficient framework for disciplined national budgetary policies in an EMU. While this school of thought is unlikely to argue for explicit quantified upper limits on budgetary deficits, they may propose a treaty power which would enable the Council, where it judges in particular cases that deficits are excessive, to lay down binding limits on their size. This would be unacceptable to us.

3.18. We suggest that we should counter such arguments by proposing a treaty based enhancement of Community arrangements for the surveillance of economic policy.

3.19. The Community has agreed to improve the arrangements for coordinating Member States' economic and monetary policies in Stage 1 of EMU. The Council Decisions on Convergence and on Cooperation between Central Bank Governors have been revised to give effect to this. ECOFIN will regularly review Member States' economic policies through the process of multilateral surveillance, and may make non-binding policy recommendations.

3.20. Both the Delors report and the UK paper envisage that multilateral surveillance will continue beyond Stage 1. The difference is that Delors envisages a more prescriptive approach, including binding rules on budget deficits. The UK believes that in Stages 2 and 3 surveillance should still lead only to non-binding guidelines. The Stage 1 surveillance arrangements could therefore continue to provide an adequate framework for coordinating economic policies in stages 2 and 3.

3.21. However, it would help our case in arguing against binding budgetary rules for the size of deficits if we agreed to some strengthening of the surveillance procedures after Stage 1. This could be done through a further revision of the Convergence

Decision and - possibly - certain amendments to the Treaty. A possible package (for adoption in Stage 2 or Stage 3) could include:

- specifying the range of economic policy and other indicators on which ECOFIN will annually make non-binding recommendations;

- member states would be required to respond formally to the recommendations;

- the Commission (or an alternative body such as the EMF) would be required to monitor member states' performance and report to the Council;

- in some cases, where there are budgetary problems, special consultative procedures and tighter monitoring arrangements would be specified;

- compliance with surveillance procedures would be binding, although Council recommendations would remain non-binding.

Sanctions

3.22. Inclusion in the Treaty of rules on budgetary matters, of the sort supported in this report, or the binding budgetary rules advocated in the Delors Report, raises the issue of sanctions against member states who fail to comply with the new requirements.

3.23. In principle, member states who breach such rules can be taken by the Commission to the European Court of Justice, which can order compliance. But this procedure is both cumbersome and time consuming and there is no effective sanction for non-compliance. Some Member States may therefore argue for introducing specific sanctions when EMU rules are flouted. Withholding Community funds is one obvious option. Others may argue that no specific sanction should be prescribed at the outset, but should be considered as EMU progresses; for this purpose it would be necessary to incorporate in the Treaty powers to enable the Council to prescribe sanctions.

3.24. We believe that it will be difficult in practice to secure agreement amongst Member States on specific sanctions to back up EMU rules. As far as the UK is concerned, we do not want to encourage unnecessary centralisation of powers in the Community. At the same time, we need to be sure that the rules we favour are actually applied: the Community's readiness to take tough decisions is at present questionable.

3.25. The best approach for the UK may be

- to let others raise the question of sanctions;

- if they do, to point out that a willingness to adopt any binding rules must be accompanied by determination to see that they are applied. That points <u>either</u> to specific sanctions, <u>or</u> to a much tougher political attitude among member states;

- to insist on strict conditionality for Community financial assistance, with the implication that such assistance would be withheld if the member state concerned did not meet the economic conditions set down;

- to accept if necessary that <u>existing</u> sanctions would apply to a no monetary financing rule: ie peer pressure with ultimate recourse to the European Court;

- to argue that rules on budget deficits should not be binding, and should not therefore be backed up by sanctions.

<u>A minimum average maturity rule</u>

3.26. Another possible binding budgetary rule that we might propose is that the Council should have powers to stipulate that new Government debt should be of a minimum average maturity. The rationale for such a rule would be that one sign of excessively large budget deficits is the inability of budget authorities to finance their debts other than at fairly short maturities. Such a rule would not amount to a direct limitation on Parliamentary authority, and would be consistent with both our domestic funding rule and our support for a non-monetary financing rule in the EC context.

3.27. This proposal might be held in reserve as a possible way of dealing with pressures for binding rules on the size of budget deficits. However, its implementation could raise practical problems even for countries with a strong fiscal position like the UK; and we are considering whether it could be specified in some other form which would avoid these.

## The Commission's "Bid and Offer" System

3.28. The Commission are considering this idea, in which each member state would propose a budgetary rule for itself to follow, seeking agreement with the Council on this basis. Rules based on such an approach, which amounts to each country negotiating its own MTFS, may be easier to agree than rules based on absolute criteria of some kind.

3.29. But the fundamental distinction, between rules that are binding and those that are not, applies as much to this system as any other. We could probably accept such a system as a basis for non-binding surveillance. But we could not accept that reaching agreement on a rule should be obligatory, still less that any rule should be binding on the country concerned.

## Economic and Social Cohesion

3.30. There will undoubtedly be pressure from some member states - in particular, the southern member states and Ireland - for the inclusion of material on economic and social cohesion in a new Treaty. This will reflect not only a genuine concern about the possibility of adverse effects from EMU on the peripheral regions, but also a need to convince public opinion in their own countries that there is some prospects of sharing in the gains.

3.31. We might be able to accept some additional material in a Treaty on the desirability of economic and social cohesion. But it will be essential to avoid any specific commitments to particular measures, for example in relation to the size of the structural funds. The emphasis should be on the mechanisms by which the poorer countries will be able to catch up, and measures which will enhance them, rather than on the redistribution of gains from EMU to the poorer countries; redistribution will of itself tend to inhibit adjustment. As regards mechanisms, our approach stresses the need to enhance market forces and flows of private capital, rather than flows of official capital in the form of subsidies which are likely both to be inefficient and to inhibit adjustment.

## Subsidiarity

3.32. A key objective for the UK will be to have written into any Treaty provisions on EMU a clear definition of subsidiarity in the economic policy field together with explicit reservation of certain parts to national governments.

## IV VIEWS OF OTHER EC MEMBER STATES

4.1. Summary notes on the current views of other Member States on the broad Delors Report and IGC issues are attached at Annex B. Three general themes emerge.

4.2. First, all other Member States advocate progress towards Economic and Monetary Union. For some (eg Italy, FRG, Benelux) it is seen as a necessary and desirable step on the road to political union; for others (eg France, Denmark) as essential if increasing de facto Bundesbank control of Community countries' monetary policies, and the economic dominance of the FRG, is to be diluted. German unification is likely to strengthen both perceived reasons for advocacy of EMU, and early Treaty change.

4.3. Second, all other Member States accept the definitions of EMU set out in the Delors Report and the need for institutional developments. Some aspects of the UK paper have attracted widespread support, including in France and the FRG, but the central thesis that an eventual monetary union need not entail a single monetary policy, or any common institutional framework, has evoked no governmental support.

4.4. Third, all other Member States also accept the Delors Report's thesis that monetary union necessarily entails concomitant economic union, with some binding budgetary rules. But there is no agreement on the precise form of such rules, particularly whether they should place limits on national budget deficits, as recommended in the Delors Report.

4.5. Views on the likely pace at which EMU might in practice come about, using new Treaty provisions, differ widely. Central Banks tend to envisage a slower timetable than do governments, and within governments Finance Ministers tend to be more cautious than Prime Ministers. The implausibility of very rapid progress on a Community basis, ie involving all Twelve countries, is rarely discussed. Those Member States (eg Ireland, Portugal, Greece and perhaps Spain and Italy) whose economies plainly could not in the short/medium term sustain full economic and monetary union with the FRG retain hopes, fed by the Delors Report, of an expanded EC budget to narrow regional and structural disparities through redistributive resource allocation. (For them a central defect of our "Evolutionary Approach" was that it dashed such hopes, pointing instead to market forces as more efficient in narrowing disparities.) On the other hand, most of those Member States (France, Benelux) who, like the UK, probably could sustain full economic and monetary union with the FRG, share our opposition to a much bigger redistributive budget, but shy away from "uncommunautaire" acknowledgement that full EMU might not be reached by all willing partners simultaneously. They are likely, however, to accept a continued high level of structural fund spending beyond 1993 as the necessary political price for getting the southerners on board.

4.6. More often discussed is the question of whether willing partners could or should wait for an unwilling UK. This issue of course concerns the pace and nature not only of actual progress towards EMU but also, much more imminently, of the IGC. All Member States claim to want the IGC to end with the unanimity necessary to amend the Treaty and most such claims (certainly in the FRG, the Netherlands, Denmark, Luxembourg, Spain and Portugal) probably are genuine. EMU would be weaker if sterling were excluded; and the legal problems of a new Treaty of Eleven, though not insurmountable, would be formidable. But, for the reasons set out at paragraph 4.2, our present assessment is that in the last resort even our closest partners - the Dutch and Danes - if forced to choose between a nugatory IGC or a split IGC, would probably prefer a split, and agreement among Eleven. Their current hope is that the development of positions during the IGC will mean that they do not have to face such a choice. No doubt most statements on this aspect have both an element of the tactical in them (making UK flesh creep) and an element of substance.

## V ISSUES FOR CONSIDERATION

5.1. Our report suggests that the following are the main issues on which Ministers will want to focus their attention, in determining their strategy both in the approach to and during the forthcoming IGC.

**The IGC and progress towards EMU**

- The important distinction between the pace of an IGC and of actual practical movement towards EMU. (Paragraphs 1.3-1.4)

- The implications of recent developments in Eastern Europe and GMU. (Paragraph 1.5)

- The assessment of other member states' views on a new Treaty. (Paragraphs 1.8 and 4.1-4.6)

**The form and general content of an amending Treaty**

- Our analysis of the four options in paragraphs 1.9 and 1.10.

- The discussion about the importance of "firebreaks". (Paragraphs 1.11-1.12)

**Definition of full monetary union**

- The difficulties of avoiding the definitions in the Delors Report. (Paragraphs 2.4-2.5)

- The change in the UK position involved in accepting the Delors' Report position. (Paragraph 2.6)

- The acceptability of the ultimate objective of irrevocably linked currencies. (Paragraph 2.7)

- The possibility that irrevocably locked exchange rate parities would be inherently unstable. (Paragraph 2.9)

<u>Institutional developments after full monetary union</u>

- Identification of the four key issues in paragraph 2.15: the fundamental objective of an ECMI; its degree of independence; its democratic accountability and its policy responsibilities.

- The fundamental objective of an ECMI (paragraph 2.16)

- The choice between an independent ECMI and one controlled by the Council of Ministers. (Paragraph 2.17)

- The distinction between political control and democratic accountability. The problem of delivering proper accountability in practice. (Paragraphs 2.18-2.21)

- The question of whether exchange rate policy should rest with an ECMI or with Finance Ministers/Central Bank Governors. Our ideas for alternative arrangements to those proposed in the Delors Report. (Paragraphs 2.22-2.28)

- Questions concerning responsibility for banking supervision under an ECMI. (Paragraphs 2.29-2.30)

- "Gold Standard" options. (Paragraphs 2.31-2.33)

<u>Interim institutional steps in Stage 2</u>

- The arguments for and against proposing interim institutional developments. (Paragraph 2.34-2.36)

- Our ideas concerning the creation of an EMF, and its three possible functions. (Paragraphs 2.37-2.42)

<u>Budgetary policy rules: possible UK initiatives</u>

- Our assessment of the Delors Report recommendations, and some fresh proposals for moving forward. (Paragraphs 3.5-3.8)

- The acceptability/workability of rules prohibiting monetary financing and Community "bail-outs". (Paragraphs 3.9-3.11)

- Our ideas for attaching binding conditionality on EC balance of payments support loans to member states, and whether this could be a role for an EMF. (Paragraphs 3.12-3.16)

- On enhanced arrangements for Community surveillance, the package of ideas outlined in paragraph 3.21.

- On sanctions, the pros and cons of the approach outlined in paragraph 3.25.

- The possibility of a minimum average maturity rate rule. (Paragraphs 3.26-3.27)

- The Commission's ideas for a "bid and offer" system. (Paragraphs 3.28-3.29)

Economic and social cohesion

- The importance of offsetting pressures from southern, etc member states for Treaty language which may create future commitments for increased expenditure on regional support. (Paragraphs 3.30-3.31)

Subsidiarity

- Definition of areas of economic policy to be reserved explicitly to national governments. (Paragraph 3.32).

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ANNEX A

**Timetable**

Key dates in the timetable are:

**1990**

| | |
|---|---|
| 5/6 March | Foreign Affairs Council will discuss scope of IGC and role of European Parliament in IGC process. |
| 31 March/1 April | Informal ECOFIN will discuss reports on EMU from Commission and Monetary Committee. |
| April-May | Further preparatory work by ECOFIN (monetary and economic issues) and FAC (initial discussions of institutional aspects probably unavoidable). |
| 24-25 June | Dublin European Council. No indication yet how Irish will play EMU. |
| July-December | Italian Presidency. Preparatory work for IGC likely to take place in ECOFIN, FAC and possibly special group(s). |
| December (probably) | IGC formally convened. |

**1991**

| | |
|---|---|
| January-June | Luxembourg Presidency. Substantive work on IGC will get underway. |

Until the IGC meets, and particularly before the European Council in June, there will be opportunity to influence the debate on EMU and feed in further ideas if Ministers wish to do this. The timing and tactics for doing this will need further consideration in the light of Ministers' views on strategy. But if we have ideas, it will be important to seek support for them before the IGC. Once the IGC has opened, the Commission and other Member States are likely to table detailed Treaty amendments, perhaps at an early stage. So the coming months will be crucial.

## EMU: VIEWS OF OTHER MEMBER STATES

1. BELGIUM
2. DENMARK
3. FEDERAL REPUBLIC OF GERMANY
4. GREECE
5. SPAIN
6. FRANCE
7. IRELAND
8. ITALY
9. LUXEMBOURG
10. NETHERLANDS
11. PORTUGAL

## 1. BELGIUM

Belgium continues to be amongst the most ardent supporters of EMU, fully supporting the Delors Report definition of EMU, and criticising the UK paper as no more than Stage 1 plus. The Central Bank and Finance Ministry believe in fully implementing Stage 1 before moving on, and sees no particular hurry. But the Government as a whole would certainly join any pressure from elsewhere for an early end to stage 1.

Formally, there is not yet a government position on the form and substance of an IGC, but the Belgians have never disguised their wish that it should extend widely, increasing the powers of the EP and the Commission, and reducing those of the Council of Ministers. No mention is made in Belgium (even by members of the Parliament) of the question of accountability to national Parliaments.

Both the Central Bank and the Finance Ministry believe that convergence of budgetary policies cannot be left to market forces. Senior Belgian politicians have not yet focused on the implications of Delors' views on binding budgetary restraints, even though the Belgian budget relies on massive annual deficit financing. Nor are there concerns in Belgium about loss of monetary sovereignty. On the contrary, the Belgians believe they would gain a voice, albeit a modest one, through EMU and the ESCB, as opposed to the present situation of Bundesbank domination.

The Central Bank is unlikely to differ from the Government on any EMU issue. The Governor (Verplaetse) was until July 1989 the Prime Minister's key adviser on economic issues, and remains very close to Martens.

## 2. DENMARK

The Danes do not think Delors provides all the answers for EMU; they have problems on fiscal policy and on the institutional side. Some now question the need for Stage 2 and envisage a long Stage 1. Opinion is cautious about when, how, and whether to move to Stage 3.

The Government are bound by a Folketing Resolution to work for an IGC with a mandate covering economic and exchange rate cooperation, closer cooperation with the EFTANS and Eastern Europe, and qualified majority vote decision-making on environmental and labour market matters. But they could, at the end of the day, accept a narrower remit. The Danes want to see a one-part conference.

Denmark thinks democratic accountability not too difficult to achieve. They think governments should make appointments to the ESCB Council or Board; and Board members should appear as needed before the EP and submit reports to other Community or national institutions, including Parliaments. The Danes foresee operational as well as political difficulties for binding budgetary rules given the difficulty of precise budget deficit and surplus prediction.

~~Yet~~ The Government has broad political support, though the Social Democrats and the Socialist People's Party have some doubts about Stages 2 and 3.

3. FRG

The Germans say that their commitment to EMU remains unaffected by what is happening in Germany and that they will keep to the timetable of an IGC in December but without bringing it forward. Kohl is no doubt sensitive to the risk that the French will accuse him of going back on his commitments. However, it remains to be seen whether once the Germans have fully digested the implications of unification, they will remain as enthusiastic as before for EC political union and for EMU.

Implementing German monetary union is likely to lead to a less stable monetary environment and a German desire for continuing monetary autonomy. Moreover the need for budgetary flexibility to provide help for the GDR may make the Finance Ministry even more wary than they already are of binding budgetary rules. All this could persuade the Germans of the need for an even longer Stage 1 than previously envisaged, though they have not yet thought this through.

The Germans accept the definitions in the Delors Report. Their central concern is to guarantee the stability of the currency, which they see as being best provided for by an independent European Central Bank. They have not yet thought much about the content and length of stages beyond Stage 1. The Finance Ministry, the Economics Ministry and the Bundesbank do not like the prospect of big resource transfers as sketched out in Delors Stage 2 and like to gloss over this phase. Kohl has more than once said that the powers of the European Parliament should be increased. The Germans have not addressed the issue of how to divide the IGC agenda.

Pöhl gave a personal view of how to achieve accountability in his speech in Paris on 16 January. The main German point is to minimise political accountability. He wants an ESCB as independent as the Bundesbank. There is a debate about whether what accountability there is should be primarily to the ECOFIN and Monetary Committee (the view of the Bank) or, and if so to what extent, the European Parliament. The attraction of the Parliament to the proponents of its having a say is that this puts some flesh on Kohl's commitment to increase the powers of that institution.

The Bundesbank want binding fiscal rules. The Finance Ministry are less certain of the need for this and there is a constitutional problem because of the fiscal powers of the Länder. EC rules might require amendment to the constitution, but this could infringe the Basic Law.

## 4. GREECE

Athens will not focus seriously on EMU issues until after the 8 April elections, and even at official level a theoretical position has not been worked out. Greece broadly accepts the Delors definition of EMU, though some have reservations on the need for fiscal harmonisation. There is general opposition to ideas of reducing the length of Stage 2; experts speak of the need for an "evolutionary" approach which might include more than three stages. The Greeks also argue for a protracted Stage 1, given the difficulty of predicting how long it would take Greece to fulfil its requirements. There is concern that Greece could be left outside EMU if it found it difficult to move from one Stage to another.

There is no agreement on the scope of the IGC. The MFA prefer a wider IGC which under one roof would cover EMU and relevant institutional provisions. The Bank of Greece argue for an EMU-specific IGC. All sides see a need for an enhanced role for the European Parliament. There is no indication that binding budgetary rules could cause constitutional difficulties. Indeed officials think them highly desirable for a budget deficit which reached 22% of GDP last year. But there is no doubt they would cause considerable political difficulties. Greece is likely to be an early and intractable test case of the practicality of fiscal disciplines.

Tactically Greece regards itself as too small a fish to have a decisive vote an EMU. Consequently it is ultimately ready to accept EMU decisions in which it may have little faith but it will a) bargain strongly for more EC structural aid for Greece to ease economic convergence b) seek derogations and c) worry less than more principled partners about obligations that cannot be met.

5. SPAIN

For Spaniards of all shades of political opinion EMU embodies their vision of European union. At this stage the detail does not matter very much, though Spaniards will be quite cautious once discussions on substance begin.

They are unlikely to subscribe to all Delors' prescriptions. Neither the Ministry of Finance nor the Bank of Spain is happy with the idea of binding budgetary rules which might tie the growth of the Spanish economy to that of the FRG - as compared to their favourable experience in the past three years. The Ministry of Finance say that some kind of national control over budgetary regulations would have to remain. Constitutional changes are anticipated.

The Spaniards are unconcerned about the duration of the EMU process; they simply want it to begin and advance step by step. But they are concerned that the German question may knock the whole process off course.

Both the Finance Ministry and the Bank of Spain definitely want the IGC to be EMU-specific and expect the UK to be strict on limiting the areas of reform. They see it remaining in being in some form for a number of years.

Gonzalez has said that an ESCB would have to be answerable to and therefore controlled by national Governments. But others advocate a relatively independent ESCB. Gonzalez has also argued for eventual strengthening of EP powers, and there is imprecise talk of new coordination mechanisms between national Parliaments and the EP.

## 6. FRANCE

Having obtained a longed for procedural decision on convening an IGC at Strasbourg, the French are less certain what they want to do next. They accept the Delors definition of EMU, but recent events in Germany and Eastern Europe have left their thinking fluid. To some extent this reflects their view that the IGC will itself be the forum for addressing the fundamental questions posed in the report of the Guigou group.

The French appear to expect that Stage One will take around two or three years (overlapping with the IGC itself). Thereafter, Beregovoy and Tresor officials have recently been emphasising that Stage Two will be a "long and decisive" period (Beregovoy) when a balance between Community and national management of economic and monetary policies will have to be struck, and the role and tasks of a Central Bank defined. There is no common line on the timing of the move to Stage Three.

The French believe EMU is an important project straddling the economic and political fields. Mme Guigou has suggested that a revision of the entire decision making system in the Community may be called for once EMU were in place, involving in turn a reappraisal of what decisions were appropriate to be taken at which level within the Community. But the French are only beginning to think about how far these background questions should be approached at the IGC. Mme Guigou has said she does not yet have a view on whether there should be one or two IGCs.

The French have tended to see the exercise of democratic accountability in terms of the relationship to be created between the Council and the ESCB. This gives them some difficulty with the Pöhl vision of a Central Bank. The

French will probably not be enthusiastic about giving the European Parliament a major new role in any new configuration, if only because they would not want to lose any purchase over European monetary policy they gained through EMU, but they could live with a symbolic gesture.

Beregovoy has said that the question of budgetary rules is difficult: the basic powers of National Parliaments have to be respected and pragmatism and the diversity of situations should prevail. He agrees that the financing of deficits by Central Banks should "probably" be forbidden. In general the principle of subsidiarity should apply in budgetary policy. We are not aware of any constitutional difficulties in this area.

There are no serious political constraints at present evident between now and the IGC. One background factor is Delors' positioning for possible reentry into French political life after 1992, but the implications of that are not straightforward.

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## 7. IRELAND

Because they hope to improve their negotiating position in the IGC when resource provisions to ensure Community cohesion are discussed, the overriding Irish concern is to appear as good Europeans both during their Presidency and thereafter. This means that although some officials privately share British concerns about the Delors approach to EMU, they are reluctant to stick their necks out within the Irish administration let alone in public.

The Irish would prefer an EMU-specific IGC but recognise that others may want a wider agenda, and a two part IGC. Ireland's Presidency position is likely to be determined by that of the Commission. Most officials would prefer a long Stage One. But if a majority of member states favour an early move to Stage Two, Ireland will not try to slow this down.

The Irish probably accept some increased accountability at the centre and expect that the European Parliament will be involved in the IGC in some way. The leader of the Irish Labour Party has been a lone voice in expressing the need to safeguard the position of national Parliaments. Amongst officials only the DFA express concern.

There is support for binding budgetary rules as an effective discipline for small countries, though they would probably cause constitutional and legal problems. Any commitments are seen as being given only for the broad economic objectives (eg the Exchequer borrowing requirement as a percentage of GNP). The Irish are also weak on no bail-out provisions; they think that withholding Community support would be inappropriate.

## 8. ITALY

The Italians strongly support EMU, in part because they are instinctive federalists. They believe that EMU will inject discipline into the running of the Italian economy. And they hope that an ESCB will limit the powers of the Bundesbank.

The Italians support the Delors definition of EMU and strongly dislike the UK's 'alternative approach' which they tend to see as a wrecking manoeuvre and a recipe for instability.

The Italians have given little thought to the respective lengths of Stages 1, 2 and 3 of Delors (only that the overall process should be as short as possible) and are flexible on the structure of the IGC. They envisage an agenda covering the establishment of an ESCB and increased powers for the European Parliament (Italian MPs do not object to the loss of soveignty). The MFA envisage two tables at the IGC: one of 'technicians' to discuss the detail of EMU, and one of 'generalists' to discuss institutional issues. The Banca D'Italia are worried about the prospect of political interference in their area of expertise.

The Italians have some difficulties with binding budgetary rules on practical grounds. The Banca D'Italia think such a regime impossible and envisage instead a system of budgetary guidelines which would, in practice, be self-regulating.

Finally, the Italians, as Presidency, will want an early and high profile IGC.

## 9. LUXEMBOURG

Given the responsibilities of its Presidency early next year Luxembourg does not want to take up unnecessary positions now which will make an honest broker role more difficult. The Luxembourgers went along reluctantly with the call for an IGC. They regard its aims as now even more uncertain than at Strasbourg. Their main preoccupation is to prevent it spilling over into an attempt to build up the powers of the Commission and the European Parliament.

The Tresor are doubtful about the definition and purpose of Stage Two. They argue that when the Central Bank is set up it should immediately be given the power to create currency. A period of shadow control would only be a dangerous pretext for the Commission and parliament to extend their powers.

Luxembourg is quite clear in wanting the IGC to be EMU-specific, and sees no case for a second instalment.

Problems of democratic accountability do not seem to be much of a worry in an EMU context. Belgo-Luxembourg Economic Union has already taken much policy out of Luxembourg government hands. EMU is seen as a way of ensuring Luxembourg retains at least a say.

Tresor favour all member states being represented on the ESCB governing body, ECOFIN appointing Executive Directors on grounds of competence rather than nationality. Members of the Bank could appear before the European Parliament. They believe that majority voting in the governing body is not a worry if the Bank operated through market-orientated instruments.

The main domestic political constraint arises from the need to ensure adequate defence of Luxembourg's financial centre.

## 10. NETHERLANDS

The Dutch are fairly flexible about how EMU is defined. They themselves have little problem with the definition in the Delors Report but they attach importance to involving major EC countries, including the UK, fully in the developments towards EMU and will be prepared to agree to look at other wording if this enabled consensus to be reached.

The Dutch are also flexible over whether arrangements leading up to EMU will involve only one, or more stages. They think it more important that participants should be satisfied that key questions have been properly dealt with.

The Ministry of Finance believe that the IGC should be EMU-specific, and that it would be too difficult to look simultaneously at wider institutional issues. However, the MFA view is that the IGC must inevitably consider the role of the European Parliament in the EMU process, and that early decisions will be necessary on how to associate the Parliament with the work of the IGC. This accords with the view of many Dutch parliamentarians who are concerned more generally with the question of the "democratic deficit": and with the inclinitions of Dankert, state secretary for European Affairs, who has said that he could see the arguments building up in favour of extending the remit of the IGC beyond EMU alone.

On democratic accountability, the Dutch continue to dismiss worries about this as unreal. They argue that there need be no major problems if the role of the bank is limited, as the Delors Report suggests, to ensuring price stability. Their proposals envisage that Bank Governors should be nationally nominated for fixed terms, that the Bank should have requirements to report to the Council of Ministers, and that the Bank mandate should require approval by national legislatures.

On binding budgetary rules, the Dutch have yet to come to a final view. Here, too, there is some difference of outlook between the Finance Ministry and the MFA. The Finance Ministry acknowledge that such rules might contribute to political difficulties rather than overcoming them. The view of the Netherlands Bank had earlier been that an independent Central Bank would not be able to operate without binding rules. However, they and the Ministry of Finance are now considering the possibility of broader disciplinary guidelines rather than binding budgetary rules. The MFA is still open to the idea of binding budgetary rules and indeed see some advantage in them as a means of imposing budgetary discipline on countries such as Greece and Italy.

## 11. PORTUGAL

A Government reshuffle in early January brought in a new Finance Minister, Miguel Beleza, who has so far made no public statement on EMU. But the Portuguese position is unlikely to have changed much since Strasbourg. Economic and social cohesion are paramount, and to gain acceptance in Portugal any approach to EMU must include redistributive mechanisms. A study commissioned by former Minister Cadilhe is underway in the Ministry of Finance on the technical aspects of EMU, but it will not make political recommendations. The Portuguese have no view on the timing and staging of the EMU process. The general assumption is that a wider conference is inevitable.

They take no position on democratic accountability. Some widening of the powers of the European Parliament would not be unthinkable, and might even be welcomed given the youth of democracy in Portugal. Implementing binding budgetary rules may well give the Portuguese difficulty during the current phase of rapid modernisation. Portuguese advantage would in any case lie in seeking a few years' derogation rather than opposing in principle.

The Portuguese have particular problems with the timing of the escudo's entry into the ERM as part of Stage 1 because of high inflation and the existing policy of crawling-peg devaluation. They also fear the centripetal effects of EMU Stage 1 on capital; capital flights could slow economic development significantly.

The Government and the Central Bank made considerable efforts during 1989 to reach common positions. The appointment of Beleza, himself previously a Director of the Bank, is likely to bring the two even closer. But the Bank is currently so depleted it has not even been sending a representative to the Monetary Committee.

LIST OF ADDITIONAL ANNEXES, AVAILABLE ON REQUEST

1. An Indexed ECU Standard. *(Paragraphs 2.31-2.33)*

2. An ECU Currency Board. *(Paragraphs 2.37-2.39)*

3. Administrative Arrangements for Community Assistance at Different Stages of Monetary Integration. *(Paragraphs 3.12-3.16)*

4. One Variable as the Centre of Budgetary Policy? *(Paragraphs 3.17-3.21)*