

Committee of Governors of the
Central Banks of the Member States
of the European Economic Community

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(Translation)

THE MONETARY STRUCTURE OF EUROPE

WORKING DOCUMENT BY THE OFFICE OF THE CHAIRMAN OF THE ALTERNATES OF THE COMMITTEE OF GOVERNORS

INTRODUCTION

At its meeting on 8th March 1988 the Committee of Governors requested the Alternates to prepare for the execution of the mandate from the ECOFIN Council to examine the memorandum by Minister Balladur. It was agreed that the Alternates would discuss the matter in depth at their April meeting on the basis of a preparatory working document by the office of the Chairman. In addition, the Governors issued the following guidelines:

- to begin with, the mandate should be clarified by outlining precisely the issues to be examined;
- the work should relate to the whole of Minister Balladur's memorandum and hence not be limited to the institutional issues contained in its final section;
- although the mandate relates essentially to examination of the Balladur memorandum, the notes presented by other official figures should also be taken into consideration.

The sole aim of the present note is to advance the discussion as far as possible. It contains two parts: the first attempts to outline the problems currently affecting the EMS by describing its "imperfections" and their implications as identified in the reference documents; the second tentatively selects and regroups the issues which require clarification before a decision is taken on any follow-up to the work.

I. THE IMPERFECTIONS OF THE SYSTEM IN ITS CURRENT FORM AND THEIR IMPLICATIONS

On the basis of the reference documents, the factors that raise problems may be presented as follows:

- (1) Progress in convergence has not been accompanied by satisfactory results in other spheres such as economic growth, employment and current-account balances. While an unwinding of current-account disequilibria based exclusively on exchange rate adjustments would jeopardise the future of the EMS, demand-oriented policies also do not hold out the prospect of a rapid return to equilibrium. In fact, there appear to be structural factors preventing significantly faster growth of domestic demand in the countries with large surpluses; consequently, the other countries may find themselves obliged to scale back their own growth targets. This gives rise to fears of a deflationary bias, or at the very least an insufficient ability of the System to foster sufficiently dynamic economic growth in Europe.
- (2) The convergence of inflation rates towards the lowest level and the emergence of the Deutsche Mark - albeit largely spontaneous - as the intervention and reserve currency within the EMS sustains an asymmetry in the distribution of the adjustment and financing burden. As the convergence of inflation rates progresses, this asymmetry may have the effect of exempting countries with overly restrictive policies from adjustment efforts. It is also noted that this asymmetry risks perpetuating a tendency for the EMS currencies to appreciate vis-à-vis the dollar area and that it may be used as an argument in favour of non-participation in the exchange rate mechanism.
- (3) The co-ordination of monetary policies, in its present form, is considered insufficient to preserve what has been achieved on the exchange rate front in an environment of free capital movements.
- (4) Non-participation in the exchange rate mechanism reduces the practical impact of the liberalisation of capital movements, maintains inequalities as regards constraints and jeopardises the opportunities for future strengthening measures, in particular at the institutional level. In the long run, non-participation by countries which nevertheless appear to have the economic and monetary ability to join may raise fundamental questions concerning the very concept of monetary co-operation within the Community.

- (5) Even if the absence of a more precisely defined policy vis-à-vis third currencies does not necessarily prevent an effective defence of the System against external shocks (for example the fall of the dollar since February 1985), it represents a gap in the Community decision-making process and tends to weaken the international weight of the Community.
- (6) The System as it operates at present is not irreversibly oriented towards a unified currency area. It makes no provision for any subsequent step in the event that the goal of stability is achieved. Opposition to institutional reforms means that progress can only be attempted little by little.

It would seem useful to assess this analysis by attempting to answer the following questions:

- (a) To what extent is there agreement on this analysis, or to what extent is it considered to form an acceptable basis for discussion?
- (b) Can the System in its present form put up with these weaknesses, or is the status quo unacceptable?

II. CONDITIONS AND AVENUES FOR PROGRESS

The reference documents cover a very large area, making it necessary to select or regroup the issues raised. Moreover, a number of these issues are the subject of work recently done or still in progress.

The external cohesion of the System and the problems inherent in non-participation in the exchange rate mechanism were dealt with in the opinion of the Governors that formed the basis for the Basle-Nyborg Agreement. The implications of the liberalisation of capital movements for the operation of the EMS will form the subject of the opinion of the Committee to be submitted to the ECOFIN Council in April, and certain fundamental aspects will probably be examined in greater depth by the Raymond Group.

It must be admitted, therefore, that the general background to these three imperfections is fairly well known and that the proposals to be examined do not appear to introduce any new elements. Consequently, it is proposed that they be dealt with only in the context of an examination of the other concerns mentioned above, viz. the potential contribution of the EMS to more dynamic economic growth, the question of asymmetry and progress

towards a unified currency area. These three issues may, in fact, be considered to introduce an extra dimension to the set of problems surrounding the future of the EMS.

1. The absence of an engine of growth

Above all, it is the responsibility of the EMS and its potential for action in this area that should be identified.

- (a) To what extent can the rather disappointing economic growth performance among the participants in the EMS exchange rate mechanism be attributed to the System, or how far is it beyond the influence of monetary and exchange rate policies?
- (b) If current-account disequilibria persisted, could they be offset by a transfer of resources that would contribute towards a convergence of living standards within the Community? In this regard, too, it would doubtless be necessary to admit the limitations of the mechanisms of the EMS.

2. Asymmetry

This problem area concerns both the fundamental options and day-to-day operation.

- (a) While the basic texts contain elements of symmetry, the System has evolved along different lines. Hence it was judged necessary to accept the asymmetrical model in order to achieve progress towards stability. From this point of view, this model is regarded by some as an indispensable element in the credibility of the system. For others, perseverance with this model will become the point on which the System founders or at the very least an obstacle to its reinforcement and enlargement. Is there a means of reconciling these two approaches?
- (b) The reference documents address the three kinds of asymmetry discernible in the present model, viz. the priority given to price stability in overall economic policy objectives, the predominant position of one currency in the technical operation of the system and the influence wielded by a single country's policy. Leaving questions of principle aside, the ways and means suggested for reducing these asymmetries also raise practical issues:

- A shift away from the "absolute" priority of price stability towards the furthest possible attainment of economic policy objectives would seem to necessitate for the operation of the System a decision-making and policy-formulating capacity at ECOFIN Council level that does not currently exist. Should this be taken as proof of a close link between reducing asymmetry in this area, on the one hand, and the need for a strengthening at the institutional level, on the other?
- Is there not a risk that the diversification of reserve assets will be reflected in an involuntary increase in the resources available to the countries whose currencies are more widely held? Is there not a risk that this diversification will heighten instability as a result of massive conversions of reserve assets at inopportune moments? How may such a diversification be reconciled with the proposals put forward for strengthening the role of the ECU?

3. Progress towards a single currency area and a European central bank

According to the Balladur memorandum "it would be logical to create a single currency area, that is to say an area in which one denomination would have the force of legal tender in all the countries and in which there would be a common central institution and "federal" banks in each country".

Given that the general principle of a European central bank seems to be virtually undisputed, it is fundamentally a question of deciding when, how and under what conditions. In this connection one should address the question of the powers of a European central bank and the preconditions for its establishment.

(a) **What would be the powers of a European central bank and its relations with the political authorities?**

Generally speaking, it would appear premature to examine these questions in detail; it would, moreover, be impossible within the time available. At best, there should be a very preliminary discussion insofar as this would enable the preconditions for the establishment of a European central bank to be more clearly defined. Might one envisage a gradual approach to the granting of powers to a central monetary institution?

(b) **What are the preconditions for the establishment of a European central bank?**

The following conditions, in particular, may be cited from the reference documents:

- the implementation of freedom for capital movements;
- participation of all countries on equal terms;
- greater co-ordination of monetary and economic policies in general and fiscal policies in particular;
- convergence of economic performance and living standards;
- the final creation of official ECUs, the fusion of the two ECU circuits and the replacement of the basket composition by an autonomous currency definition;
- fixed exchange rates for national currencies or their replacement by a single currency;
- convergence of national central bank statutes;
- political unification or the existence at Community level of a political authority with the competence to provide the necessary guarantees for the exercise of monetary powers.

A first set of questions relates to the scope of the examination to be undertaken: should this be restricted to the drawing-up of a simple list specifying the conditions, or should a more detailed programme and timetable for the measures to be taken be agreed? Should the Governors form a view of the whole process, including the conception of the subsequent phase, or should they above all draw the attention of the political authorities to the "other" conditions to be fulfilled before being able to make any advance in the areas that are the specific concern of the central banks?

A middle course between a simple listing of the chief conditions and the outlining of a plan of action might consist in the formulation of some general guidelines. These might issue, for example, from an examination of the following questions:

- How far could or should the so-called non-institutional phase be continued? For example, should the participation of all the EEC

member countries in the exchange rate mechanism be awaited before it is possible to envisage institutional reforms necessitating the application of Article 236 of the Treaty pursuant to Article 102 (a) of the Single European Act?

- Is the model of the final system referred to in Article 1.4 of the Resolution of the European Council of 5th December 1978 still valid? What role should be given to the EMCF in the process of institutional reinforcement?
- How can the status of the Committee of Governors as the body responsible for the monetary and technical management of the System be strengthened still further? Are the pragmatic procedures sufficient to present the Committee, vis-à-vis political authorities in particular, as the natural focal point or point of departure for progress towards a common institution?