

CCB/UP

PRIME MINISTER

DELORS GROUP

You are meeting the Governor, Chancellor and Foreign Secretary tomorrow to take stock of the position in the Delors Group. You saw some papers over the weekend; others are now available.

Issues

You will want to reach a view on two points:

- i) how, in the light of today's meeting of the Delors Group, should the Governor handle subsequent meetings?
- ii) what should be your tactics when you meet Poehl next weekend?

Possible Approaches

You saw over the weekend the Governor's paper (Flag A) in which he advocated the following approach:

- He would argue at today's meeting of the Delors Group against Part II of the Report (the description of the nature of the Economic and Monetary Union) and would offer to provide a revised draft outline of this part.
- For Part III (not under discussion today) he would submit a re-draft before the next meeting of the Delors Group. This would focus on the so-called Stage 1 of the EMU, and set out proposals for early practical steps on the lines listed in Annex 1 of his minute. As to the so-called Stages 2 and 3 of EMU his re-draft would contain only "a very much abbreviated description"; it would not describe the form, content or timing of any Treaty change.

The Chancellor has now sent in a minute (Flag B) disagreeing with this approach. He argues that Parts II and III of the present draft Report are so bad that it is impossible to

expect that the Group will agree to an acceptable re-draft. He therefore proposes that the Governor should in effect declare UDI from the rest of the Group and submit a free standing statement of his own views and conclusions. This would focus on positive steps that can be taken to enhance economic and monetary co-operation, and argue that a fundamental amendment to the Treaty goes beyond the competence of the Group.

Other papers in the folder (not required reading) are:

Flag C note by the Cabinet Office;

Flag D the draft of Part II under discussion in the Delors Group today;

Flag E the draft Part III which was discussed at the January meeting of the Group;

NB: The Governor is sensitive to the fact that he is on the Delors Group in a personal capacity; he would not want you to reveal to Poehl that you have seen drafts of the report.

#### Handling

You may like to start by asking the Governor to report on the outcome of today's Delors Group meeting. In the light of that, does he still feel that the strategy set out in his minute at Flag A is the right one?

You could then ask the Chancellor to speak to his minute.

You will want to consider carefully the respective merits of the Governor's and Chancellor's different approaches. Charles and I both feel that, unless the Governor has had unexpected success today, the Chancellor is being the more realistic, and that at some point the Governor will have to submit a statement of his own views - in effect a minority report. Certainly that should be the outcome if the only available alternative is signing up to an unsatisfactory consensus draft.

But the timing of submitting a separate statement needs to be considered carefully. Once this has been done, the Governor's leverage over the rest of the Group, such as it is, will disappear. So there is a case for waiting, until it is clear that there is no hope of forming an alliance with Poehl and others.

This point is reinforced by the fact that you are to see Poehl next week. The final decision on the Governor's tactics should wait until after that meeting.

That means the first priority is to settle the line you will take with Poehl. One possible approach would be:

- to remind Poehl of what he said in his earlier articles on the subject. You agreed almost completely and urge him to stick to those positions which he knows to be right;
- to argue that the Delors Report should be limited to the sort of structure set out on page 2 of the Chancellor's minute (Flag B);
- to explain to Poehl what we can live with in terms of the substance of a report and test his reactions;
- to feel out whether he might be prepared to join the Governor in a minority report.

We might then arrange a further meeting later next week to decide how the Governor should, in the light of the Poehl meeting, proceed. Meantime, you could ask the Governor to put in hand the re-drafts he suggests in his minute.

*Acc.*

PAUL GRAY

14 FEBRUARY 1989

CONFIDENTIAL

C  
CCBYOR

Qz06294

MR GRAY

DELORS COMMITTEE: PRIME MINISTER'S MEETING ON 15 FEBRUARY

I attach a brief on the paper circulated by the Governor's Office on 10 February and the Chancellor's minute of yesterday.

2. The Governor is attending a meeting of the Delors Committee today and something will turn on his latest impressions of the climate of opinion there. The brief suggests that if counsels of moderation are being heard again, it may be too early to assume that the Governor needs to table a minority report - in effect the Chancellor's proposal. An alternative tactic might be to table a paper, on the lines of the Chancellor's proposal, plus a revised Part III to the Committee's report, as recommended by the Governor.

3., The Prime Minister may conclude that drafts of both papers should be prepared as soon as possible, for clearance if necessary in a resumed meeting.



R G LAVELLE

14 February 1989

## DELORS COMMITTEE: MEETING ON 15 FEBRUARY

### A. Purpose of Meeting.

To hear the Governor's report on the most recent meeting of the Delors Committee (on 14 February); to consider whether he should circulate a UK paper before the next meeting and if so to decide what it should say.

### B. Background

#### i. Prime Minister's meeting on 14 December.

At the last Ministerial stocktaking the Governor was asked to seek to ensure that the Delors Committee's report was descriptive not prescriptive; that it spelled out the full implications of EMU in terms of loss of national sovereignty; that it made clear that EMU was not necessary for completion of the single market in 1992; and that there should be no recommendation for Treaty amendment. The meeting commissioned production of a possible UK paper setting out practical steps we could support which might be tabled in liaison with Poehl.

#### ii. Delors Report: general state of play.

The Bank of England paper of 10 February recalls that it has been envisaged since October that the report would have three parts, the first describing historic developments, the second being an account of the nature of economic and monetary union and the third suggesting "concrete stages" to that end. As discussed below the drafts of Parts II and III have subsequently been given a pronounced prescriptive and institutional content. Discussions have now reached a critical phase. There are now only two meetings of the Committee (in March and April) before the report is submitted to ECOFIN in May.

iii. Part II of the report.

The Governor will report at tomorrow's meeting on the discussion of the latest version of Part II of the report and the Committee's reception of his alternative draft outline. As his note of 10 February said, the current draft is unsatisfactory in a variety of ways. In particular it is prescriptive rather than descriptive, suggesting the need for Treaty change, new institutional arrangements and the adoption of the ecu as a common currency. It is preoccupied with an unreal elaboration of a post-1992 world. It notes at least some of the implications of EMU for sovereignty. Thus it accepts apparently without qualms, that setting a brisk pace for attainment of EMU will require replacing market forces, | eg exchange rate adjustments, by increased central regulation and increased structural funds. But the Report signally fails to draw the conclusion that this prospect is such as to rule out its attainment for the foreseeable future: and it seeks to disguise some of the less palatable messages by references to gradualism or the "principles of subsidiarity". The motor for EMU appears to be the desire for a central monetary institution for which the logical counterpart has to be greater political union having extensive ramifications. The Bundesbank is bought off by a design for a future central bank having a similar autonomy. With no model similarly to hand, the institutional proposals for economic union are an undefined revamping of existing institutions.

iv. Part III.

The Governor's paper summarises the current draft of Part III with its three stages towards economic and monetary union. Stage 1 would begin with the completion in July 1990 of capital liberalisation and there is an expectation of its completion by 1992. As drafted stage 1 would encompass some further coordination of economic and monetary policies but little in the way of concrete steps. It is also envisaged that during that period a process of Treaty amendment would be set in hand. Although a variant including early

establishment of a Reserve Fund has apparently been dropped, Stage 1 of the report still includes a number of additional unacceptable elements eg provision for implementation of a tax on savings and language suggesting a fuller Community role in decisions on national tax rates and monetary policies than is acceptable. The process of Treaty amendment envisaged would provide for sufficient powers, introduced by stages, to lead the way to full EMU without further reference to Parliament. The final stages of attainment of EMU are sketched out in a relatively perfunctory fashion, many of the institutional proposals having been covered in Part II.

**C. The Governor's proposals.**

The Governor's proposals of 10 February for bringing the report into a more acceptable form comprise:

- a shorter Part II (following an outline he has apparently offered) simply descriptive of economic and monetary union
- a substantial redraft of Part III, concentrating on the practical steps listed in his 10 February paper but also taking in acceptable points from the existing draft. He envisages that at the end a reference would be made to need to consider towards the end of stage 1 any necessary Treaty changes to implement the institutional changes contemplated in stage 2.

**D. The Chancellor's Proposals.**

In his minute of 13 February the Chancellor says that on reflection he has concluded that Parts II and III of the draft report are so bad that it would not be practicable for the Governor to secure agreement to an acceptable redraft; and that he might to get on a slippery slope if he submitted a redraft of Part III which included any material on the so-called stages 2 and 3. The Chancellor therefore favours circulating a free

standing statement of his views which might be included in the report.

#### E. Discussion.

There seems little doubt that it would be very desirable for the Governor to put in a full statement of the United Kingdom's position given the apparently very damaging drift of discussion in the Delors Group over the last meeting or so. But it may be too early to decide precisely what the objective of the paper should be. The Chancellor's judgement that it may be best to go for a free standing paper, reflects the view that the rot has spread so far that it is necessary in effect to submit a minority report at this stage. It was very much this concern which informed the Chancellor's decision to make his recent speech at Chatham House. On the evidence so far it does indeed seem implausible that a consensus could be reached in the Committee of a kind acceptable to us. The Committee has proved something of a hothouse. Some of those present may have been politically naive, or prepared to contemplate with equanimity a transfer of power to central bankers or both. The report so far is a very long way away from the proposal for concrete stages in the Hanover Council. It suggests an approach which would be wholly unacceptable to the House of Commons.

In substance however there is very little between the Governor and Chancellor's approach. Each wants a cut down Part II and III. The essential judgement is a tactical one: whether it is preferable at this stage to table a minority report (albeit with the possibility of some adherents) or to adopt a presentation which might increase the number of adherents to a moderate approach. While it may be unreal to look for a satisfactory consensus report, it may also be too early to assume the need for a minority report. A split Committee would seem preferable to the latter. At earlier stages in the Committee's work a number of moderate voices were heard reflecting the common sense view that it was too early to contemplate institutional change and distracting to think about such things this side of 1992. What has been largely missing from the Committee's discussion so



far is any animadversion to recognisably concrete steps. Those in the Governor's paper might well be acceptable to many. If enclosed in a minority report they might tend to be discounted, now and later.

Much will depend on the latest impressions of the Committee's approach which the Governor brings to the meeting. However if he can report some signs of movement back to common sense, it may be worth considering whether the optimum tactic will be to seek to carry this process a stage further while preserving the possibility of a minority report.

The prospects for the Madrid European Council are relevant here. The May ECOFIN meeting may well bring a further douche of common sense. The expectation must be that Madrid will receive the Delors Report and ask ECOFIN to work up further proposals in the light of it - with a good deal of shadow boxing over the terms of reference of that further work. Talk of Treaty amendment is unlikely to be at crisis point; if only because the French will still be on the defensive over the tax on savings. Against this background, a split Delors Committee would get matters off to a healthier start.

#### F. Content of UK Paper or Papers

If the meeting concludes that a paper on the lines suggested by the Chancellor should be one possible UK contribution, it would be worth spending some time considering its content in a little more detail, following the outline on page 2 of his minute.

Taking the sections in order the short historical review of economic and monetary cooperation is tactical in intent. A moderately constructive presentation should not be unduly controversial. The Chancellor then suggests that to replace the existing Part II, there should be a stark presentation of the massive shift of sovereignty that would be implied by EMU. Although it is clearly essential that this message should emerge clearly from this Chapter, and indeed there is a good deal of material of this kind in it already, a presentation likely to win

other adherents may need to start with an apparently neutral and technical description of some of the characteristics of EMU. The Governor's outline, which we have not seen, may suggest this. He has already made the point in a letter to Delors that the content and timing of any Treaty change are outside the expertise of the Committee. It would clearly be right to say this again.

Turning to the positive steps which could be taken in the period immediately ahead to enhance cooperation, both the Chancellor and the Governor favour putting forward the steps in the attachment to the Governor's letter of 10 February. These largely speak for themselves and consist of steps to carry forward some closer coordination of economic policies in ECOFIN together with steps to enhance cooperation on exchange rates and promote use of the private ecu. The proposals conclude with steps to strengthen monitoring of monetary policies, provision of enhanced research capacity and increased consultation over banking supervision. Two points may be noted. First, while not all the proposals would be readily accepted by Poehl, they are not so extensive in number for it to seem desirable to make this a reason for exclusion of any. Secondly, while it is tempting to include in this list a proposal for accelerated capital liberalisation, the points included in the commentary against this seem of considerable weight.

The Chancellor concludes that the UK paper should end by explaining why the approach in Part III of the existing report is flawed. A central point here is that it is clearly not possible now both to foresee conditions in the distant future and wholly unrealistic politically to set in motion a single process of Treaty amendment which would carry through to the attainment of EMU. It would be possible to combine this message with the reminder that such steps are irrelevant to the period to 1992. The achievement of the single market programme will itself impose disciplines from the bottom up. It makes sense to envisage some closer coordination of economic and monetary policies, ie top down, to complement that process.

The Chancellor's paper suggests that there should be no reference at all to the final stages of EMU or any reference to the consideration of the possibility of Treaty change eg towards the end of 1992. This is an important point. There is much to be said for leaving any such reference, if it had to be made, for a later political debate, even though the language would, at that stage as well, involve no commitment to amendment.

Paragraph 6 of the Governor's paper records his proposal to submit a substantial redraft of Part III of the report to the Delors Committee after this week's discussion. As envisaged, this paper would appear to enclose the concrete steps in the annex to his present paper in a package drawing on some of the acceptable elements in the existing draft. In tactical terms that might enhance the acceptability of this element of the UK contribution. If a double presentation were thought appropriate a proposal essentially reflecting the Chancellor's suggestion might be tabled along with a revised Part III. The latter should however eschew any account of stages 2 and 3 or reference to Treaty amendment.

#### G. Handling.

After a brief recapitulation of the outcome of the December Ministerial meeting it may be appropriate to invite the Governor to report on the latest meeting of the Delors Committee and how this may have influenced his views on the paper that he may judge it appropriate to circulate to the next meeting. The Chancellor may base his comments on the approach in his counter paper. The Foreign Secretary will no doubt comment in particular on tactical considerations. It may be convenient to deal with some of the general considerations bearing on circulation of a paper (Section E above) before considering the content of a paper or papers in more detail (Section F above).

## H. Conclusions

You may conclude that the Governor should be invited to prepare a paper on the lines outlined in the Chancellor's note, as amended in discussion. It may also be appropriate for the Governor to finalise a revision of Part III of the report, again on lines considered in discussion. Both papers should be circulated as soon as possible for clearance perhaps by a resumed meeting.



Treasury Chambers, Parliament Street, SW1P 3AG

01-270 3000

PRIME MINISTER

## DELORS COMMITTEE

WITH PG?

I have been thinking further over the weekend about the Governor's note attached to the Bank's letter of 10 February, which he had discussed with me last week.

... I fully understand the difficult situation which the Governor faces in the Committee, not least in the light of the terms of reference given to the Committee by the European Council (text attached). But after further reflection I have come to doubt whether the tactics which he suggests in his letter, and which I had discussed with him, are likely to lead to the outcome which he is seeking. My reading of Parts II and III of the draft Report suggests that they are so far from being satisfactory that he would face an impossible task in the Group to secure agreement to an acceptable redraft.

There are also, in my view, risks in submitting a redraft of the whole Part III of the Report (which would set out the steps towards EMU) as the Governor suggests. Unless the redraft were to be dismissive of the so-called stages II and III of the transition to EMU - and this would be unacceptable to some members of the Group - the redraft might give the impression that he favoured the steps which were envisaged for those stages.

I therefore feel that the Governor might well do better to submit to the Group a free-standing statement of his views and conclusions, which might be included in the Report. It is of course possible that one or two other members of the Group might support this statement: if so, so much the better.



I suggest that this statement might include the following elements:

- A short review of the history of economic and monetary co-operation in the Community, leading to the present position. Tactically, it would be right to present the value of co-operation in as positive terms as possible.
- A passage to the effect that it was clear from Group's discussion that "full" EMU, as conceived by the Group, would require massive shifts of economic and political sovereignty from member states, together with some paragraphs to provide the evidence for this in suitably stark terms.
- A comment that such a shift would require fundamental amendment to the Treaty, noting that this issue goes beyond the competence of the members of the Group - who are monetary, not constitutional and political experts, and saying that it is for Heads of State and Government to draw the constitutional consequences, and not something to which Central Bank Governors should make recommendations.
- A passage setting out the positive steps which could be taken in the period immediately ahead to enhance economic and monetary co-operation within the Community.
- A conclusion that this would be a more fruitful approach to progress on carrying forward economic and monetary co-operation than that described in the main Report, which has fundamental flaws, which should be spelt out.

CONFIDENTIAL



I hope that we can have an opportunity to discuss this approach at our meeting on Wednesday.

I am sending a copy of this minute to the Foreign and Commonwealth Secretary and to the Governor of the Bank of England.

*N.L.*

[N.L.]

13 February 1989

invited the Commission to prepare proposals for concrete measures to implement the Community's contribution to the international cooperation referred to in Toronto.

5) MONETARY UNION

The European Council recalls that, in adopting the Single Act, the Member States confirmed the objective of progressive realization of Economic and Monetary Union.

They therefore decided to examine at the European Council meeting in Madrid in June 1989 the means of achieving this Union.

To that end they decided to entrust to a Committee the task of studying and proposing concrete stages leading towards this Union.

The Committee will be chaired by Mr Jacques DELORS, President of the European Commission.

The Head of State and Government agreed to invite the President or Governor of their Central Banks to take part in a personal capacity in the proceedings of the Committee, which will also include one other member of the Commission and three personalities designated by common agreement by the Heads of State or Government. They have agreed to invite :

- Mr Niels THYGESSEN, Professor of Economics, Copenhagen,
- Mr LAMFALUSSY, Director-General of the Bank for International Settlements in Basle, Professor of Monetary Economics at the Catholic University of Louvain-la-Neuve
- Mr Miguel BOYER, President of "Banco Exterior de España".

The Committee should have completed its proceedings in good time to enable the Ministers for Economic Affairs and for Finance to examine its results before the European Council meeting in Madrid.



RA

8

PRIME MINISTER

THE DELORS COMMITTEE

You are having a further meeting with the Chancellor, Governor and Foreign Secretary on Wednesday to consider the state of play reached in the Delors Committee. This will follow the next meeting of the Committee itself on Tuesday; and precede your meeting with Pohl at the Anglo/German Summit.

The Governor has sent in today a further progress report (enclosed), which you may like to glance at over the weekend. He will give you an oral update on Wednesday on developments at the Tuesday meeting of the Committee.

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We will let you have further briefing next week.

PLG.

PAUL GRAY

10 February 1989

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cc/DP/  
CCBOP

BANK OF ENGLAND  
LONDON EC2R 8AH

*ft*

10 February 1989

Paul Gray Esq  
Private Secretary to  
the Prime Minister  
10 Downing Street  
London  
SW1

*Dear Paul*

Ahead of the Prime Minister's meeting next Wednesday I attach a short note by the Governor setting out progress to date, together with a paper that has been agreed between Bank and Treasury officials, describing possible UK proposals for early practical steps.

I am sending a copies of this letter and enclosures to Alex Allan (HMT) and Stephen Wall (FCO).

*Woms enr*

*JRM*

J R E Footman  
Private Secretary  
to the Governor

CC/SP.

A

CC/BI/SP.

## DELORS COMMITTEE: FURTHER PROGRESS REPORT

Proposed Structure of the Report

1 The Committee decided at its October meeting that its Report should fall into three parts:-

- (i) Part I would describe development and progress in the Community to date, (no draft yet circulated, but expected to be uncontroversial).
- (ii) Part II should describe as fully and clearly as possible the nature of an economic and monetary union, underlining the degree of economic union that must necessarily accompany monetary union.
- (iii) Part III was to suggest the "concrete stages" that would need to be passed through before an economic and monetary union could be put in place.

There was a clear preference that the tone of the report should be descriptive rather than prescriptive. It was also agreed (reluctantly by some) that the report should not lay down any particular timetable for moving through the various stages.

The Draft Report to Date

- (i) Part II: The Description of Economic and Monetary Union

2 A first draft was discussed in December, which devoted a great deal more space to monetary than to economic union and was also prescriptive and detailed. The redraft in the light of that discussion is on the agenda for the next meeting of the Committee on Tuesday, February 14.

The redraft is a considerable improvement. It has been quite extensively rewritten but it remains unsatisfactory - it is still long and prescriptive. The vision of the Report remains fundamentally that of a corporatist, interventionist and bureaucratic Community. More positively, however, the redraft admits that the necessary institutional framework is already in place for establishing and maintaining the single market, formulating and implementing supportive common policies and co-ordinating macro-economic policies, whereas the earlier draft implied that institutional change in the monetary field was necessary in order to complete successfully the 1992 programme.

4 At next week's meeting of the Committee I will therefore be arguing strongly for a shorter and simpler Part II that reflects the strong original preference of the Committee for a description of economic and monetary union. I will point out in particular that the Committee has already agreed that it is unrealistic to think in terms of an early and comprehensive amendment to the Treaty that would map out in detail the path towards eventual economic and monetary union. I will therefore offer the Committee a draft outline of this part of the Report on the lines that members had originally agreed.

(ii) Part III: The Description of Economic and Monetary Union

5 A first draft of Part III, discussed by the Committee at its January meeting, suggested three stages towards economic and monetary union:

- (i) Stage 1, to start at the same time as the full liberalisation of capital movements (effectively June 1990), would not involve any transfer of decision-making authority from the Member States to the Community, but policy co-ordination in both economic and monetary fields would be strengthened. Budgetary policy co-ordination would be strengthened. The Committee of Central Bank Governors would develop further the co-ordination of monetary and exchange rate policy initiated with the Basle/Nyborg agreements and institute regular meetings on

banking supervisory matters. All Member States would join the ERM and the band of permitted exchange rate fluctuations would be narrowed. At some point in this period the Community would prepare and ratify a single Treaty covering all the steps towards economic and monetary union.

Committee  
to study if joint  
ERM.

- (ii) Under Stage 2, following ratification of the new Treaty, final decisions on the conduct of policy would remain with the Member States, but there would be a gradual transfer of power to the centre. A European System of Central Banks (ECSB) would be set up along federal lines to conduct communal foreign exchange intervention and as a forum for binding ex-ante co-ordination of national monetary policies.
- (iii) Stage 3 would be marked by the irrevocable fixing of exchange rates, accompanied by a shift in the ultimate responsibility to ESCB for the formulation of monetary policy and decisions on exchange market intervention.

#### Bank of England Redraft of Part III

6 I intend to submit a substantial redraft of Part III to the Committee, as soon as possible after next Tuesday's discussion of Part II, and before the Committee's rapporteurs have submitted their own redraft for discussion by the Committee at its March meeting. This redraft will concentrate on proposals for early practical steps in Stage 1 acceptable to the UK, as listed in Annex I attached. As indicated in the Annex, not all these proposals are likely to be acceptable to Poehl.

7 It will also pick up the acceptable points from the rapporteurs' existing draft, ie,

- completion of the 1992 programme;
- strengthening Community competition policy;
- full implementation of Brussels package on structural funds;
- an increasing degree of economic and fiscal policy co-ordination;

- enhancing responsibilities and procedures of Monetary Committee in parallel with Committee of Central Bank Governors.

8 The redraft will also contain a very much abbreviated description of Stages II and III, which involve institutional change, indicating that they are illustrative of the possible direction in which the Community may wish to move.

9 I have already written to Delors to register my view that the Committee should not prescribe the form, the content or the timing of any Treaty change that a move from Stage 1 to Stage 2 may require. A brief reference will be made in the redraft to the need to consider towards the end of Stage 1 any necessary Treaty changes to implement the institutional changes envisaged in Stage 2. It may be impossible to obtain the unanimous agreement of the Committee to so unspecific a reference in the Report to the timing and content of Treaty change. In this case, it will be necessary for the Report to reflect two different views.

R. C. P.

POSSIBLE UK PROPOSALS FOR EARLY PRACTICAL STEPS TOWARDS ECONOMIC AND MONETARY UNION

Key

- A = Poehl likely to support  
 B = Poehl neutral, or attitude uncertain  
 C = Poehl likely to oppose

Economic Policy

(1) Closer co-ordination of economic policies in ECOFIN, based on regular (six-monthly?) surveillance discussion of economic developments in Community countries. Discussions to cover prospects for the fiscal stance in member countries as well as monetary policy. Central bank governors to participate, where appropriate. Discussions to be based on preparatory work carried out by Monetary Committee, Economic Policy Committee, Central Bank Governors' Committee.

Comments

A. Participation of central bank Governors is optional. But if it were recommended, that might help secure support of other Governors. Discussions could then be at informal ECOFINs, which Governors attend.

(2) Develop understandings<sup>?</sup> in ECOFIN about level of national budget deficits in a medium-term context, aiming eventually to bring deficits in all countries down to level achieved in best.

A.

(3) Develop guidelines for the financing of national budget deficits, so as to stop monetary financing.

A. A complex subject because of institutional differences in different countries. EC Monetary Committee is already studying the subject the subject, and is making some progress.

[Capital Liberalisation

(4) Implement capital liberalisation directive in all member states as quickly as possible.

B. But all except Ireland, Spain, Portugal and Greece are committed to implementation before July 1990. It may not be realistic to urge them to move faster.

(5) Member states to [agree to amend/consider amending] directive to repeal safeguard clause, which permits countries to reintroduce controls as a temporary measure, to make capital liberalisation permanent and irreversible.

B. This would provoke strong opposition from Italy and some other Southern European states, and could cause others to try to link it to an agreement to harmonise the taxation of savings. On the other hand, if others do not agree, we could make something of the argument that if they are not ready to take this minor



step, then it is idle to talk about faster progress to EMU. However, a proposal to repeal could stir up the issue of Treaty amendment too since it carries with it the implication that Articles 73, 108 and 109 (which contain similiar provisions) should also be revised.]

Increased co-operation on exchange rates

(6) A general move towards increased holdings of EC currencies in member states' reserves and their use, where appropriate, in intervention.

C. This would apply to all EC currencies, whether or not in the ERM. It is useful for central banks to have a range of currencies at their disposal so they can intervene in different currencies depending on where the market pressures are. At present holdings of other EC currencies, and their use for intervention, are inhibited by the EMS inter-central bank agreement. The measure would be permissive

only : it would not require such holdings. The Bundesbank oppose : they only hold \$s in their reserves, and wish to limit other countries' holdings of DM.

(7) Countries that do not participate in the ERM to be permitted to participate, if they wish, in the very short-term financing facility (VSTF).

B. This would enable the Bank of England to arrange short-term drawings from other EC central banks where necessary and agreed : and in return the Bank would agree to lend to other EC central banks on the same terms.

(8) Use market rate on Government short-term ecu paper as the rate of remuneration on official ecu liabilities arising in the EMS.

A. This is of no significance to the UK while we are outside the ERM, unless (7) were agreed. This would replace the present cumbersome calculation based on a basket of interest rates. It is made possible by the existence of the UK Treasury bill programme.

Promoting use of the private ecu

(9) Increased holdings of private ecu in national reserves, and their use, where appropriate, in intervention.

A. The private ecu can be a useful intervention currency. In the past the Bundesbank have not favoured this proposal because of the weight of the DM, in the ecu basket (see 6), but Poehl's attitude is now more receptive.

(10) Acceptance of private ecu in settlement of VSTF obligations in EMS, rather than official ecu.

B. Like (8) this would only be significant for the UK, as a non-member of the ERM, if (7) were agreed.

(11) Removal of national regulatory impediments that prevent market participants using the ecu in setting prices, for corporate accounts, for contracts and as a means of settlement.

A (B on some aspects).

(12) Other countries to follow UK lead in issuing government debt denominated and payable in ecu.

B.

Further enhancement of Monetary  
Co-operation

(13) Deepen and strengthen monitoring and co-ordination of national monetary policies in Central Bank Governors' Committee and Monetary Committee including :

- consideration of guidelines for national monetary policies, regular discussion of monetary targets, etc.
- discussion of the overall monetary stance of the Community, and exchange rate relationships with third countries (\$, Yen).
- discussion of monetary/fiscal policy mix in the Community.

(14) Provide Central Bank Governors' Committee with a permanent secretariat including a research capacity.

A. (Though Bundesbank likely to object to detailed discussion of monetary/exchange rate issues in the Monetary Committee, or ECOFIN.)

A. Bundesbank strongly favour building up Central Bank Governors' Committee.

Banking Supervision

(15) Central Bank Governors' Committee to start regular consultations concerning matters of common interest in banking supervision.

A. It might be feasible in due course for the Central Bank Governors' Committee to take over much of the work of the Commission's Banking Advisory Committee, with the Central Bank Governors' Secretariat taking over the Commission's functions. But this would raise difficult issues, not least for countries like Germany whose banks are not supervised by the central bank.



10 DOWNING STREET

Tessa

Could you pl. advise a  
reply with:

- Sh. Leach.

- F.C.S.

- Gowers (Bak  
+ CDP + PG.

on 15, 16, ~~16~~ or 17 Feb

to discuss the Details Grant.

After 1 1/2 hrs. pl.

[It ~~seems~~ has to be after the  
14 Feb. and before the 15th  
- Geneva summit].

REC 6 3/2

II. How to define the final stage of economic and monetary union

1. Introduction

1. The establishment of an economic and monetary union will represent the result of the process of progressive economic integration in Europe. This result will have been attained when the Community forms a single currency area in which all residents can engage freely and without impediment in any kind of economic activity, subject only to commonly applied or mutually recognised rules and regulations and supported by economic policies geared towards price stability, balanced growth and converging standards of living, high employment and external equilibrium.

2. The EC Treaties, as amended by the Single European Act, provide the legal foundation for many of the necessary steps. However, the existing Treaties do not suffice for the creation of an economic and monetary union. The realisation of this objective calls for new arrangements which can only be established on the basis of a new Treaty and consequent changes in national legislations. For this reason the union will have to be embodied in a Treaty which clearly lays down the basic functional and institutional arrangements, as well as provisions governing their step-by-step implementation.

3. Even with a single market, a unified monetary system and an institutional and functional framework for economic management, the Community will continue to consist of independent nations with differing economic characteristics, traditions, social customs and languages. The existence and preservation of this plurality and diversified structure necessitate that a large degree of autonomy in economic decision-making should continue to rest with individual member countries and that a balance

be struck between national and Community competences. For this reason it is not possible simply to model an economic and monetary union for the Community on the example of existing economies; it is necessary to develop an innovative and unique approach.

An essential element of any approach consistent with the historical and economic conditions in member countries is the distribution of economic policy responsibilities within the Community in strict conformity with the constitutional "principle of subsidiarity".<sup>?</sup> According to this principle, the functions of higher levels of government should be as limited as possible and should be subsidiary to those of lower levels. Thus, the attribution of competences to the Community must be narrowly confined to those areas in which collective decision-making is necessary, whereas all policy functions which can be carried out at national (or local) levels without adverse repercussions on the cohesion and functioning of the economic and monetary union must remain within the competence of the member countries.

With due regard to the principle of subsidiarity and taking into account what is already provided for in the EC Treaties, the need for a new structure to enable policy decisions to be taken at the Community level arises primarily - though in differing degree - in the field of macro-economic management. As a monetary union requires a single monetary policy, the responsibility for the formulation of this policy as well as decisions on day-to-day operations must be vested in one decision-making body. In the field of fiscal policy the need for centralisation is less imperative and a wide range of budgetary decisions should be left to national authorities. At the same time, however, all member countries will have to recognise and accept in their decision-making the existence of the constraints on national fiscal policy that emanate from participation in an economic and monetary union.

*with notes?*

4. A step-by-step approach to implementing an economic and monetary union can be set out only if there is a clear understanding of this final objective, of its implications for the working of the economy and economic policy decisions, and of the principal elements that have to be in place for its successful and durable functioning. Economic union and monetary union are closely intertwined, form two integral parts of a single whole and must therefore be implemented in parallel. It is for reasons of



expositional clarity that the following sections look separately at the principal features defining an economic and a monetary union. This description begins with the concept of a monetary union, chiefly because an economic union can be circumscribed more clearly and specifically once the main elements of a monetary union have been identified.

2. The principal features of monetary union

5. A monetary union describes a single currency area, which, as already stated in the 1970 Werner Report, is realised when three conditions are fulfilled:

- 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 first two of these requirements - the convertibility of Community currencies and the creation of a free and fully integrated financial market - have already been met, or will be with the completion of the internal market programme. A monetary union will, however, be accomplished only when the decisive step is taken to lock irrevocably the exchange rates between Community currencies. This will be the single most important step towards creating a situation in which all currencies can be used equally to set prices, make payments and denominate debts or credits.

6. The three above-mentioned conditions are sufficient for the establishment of a single currency area, but would not necessarily mark the end of the process of monetary unification in the Community. At a later stage the adoption of a single currency, while not strictly necessary for the creation of a monetary union, may be seen - for economic as well as psychological and political reasons - as a natural and desirable further development of the monetary union. In this connection, the Committee endorses the idea that the ECU should become the future currency of the Community and that an official declaration to this effect should be made at

the time of the decision to draw up a new Treaty. While the Treaty should allow for an appropriate period of transition, this would mean that ultimately the ECU would replace existing national currencies to serve as the only means of payment, unit of account and store of value for all residents of the Community. The introduction of a single currency would, however, be possible only some time after exchange rates had been locked and when market forces had fostered a spreading use of the ECU in commercial and financial transactions.

As a result of the permanent fixing of exchange rates national currencies will become increasingly closer substitutes: their interest rates will tend to converge and differences between prices of goods traded throughout the Community will largely disappear. However, the pace with which these developments take place will depend critically on the extent to which firms, households, labour unions and other economic agents are convinced that the decision to lock exchange rates will not be reversed. Initially, the continuing existence of national currencies may leave doubts about the commitment to unchangeable exchange rate parities and engender market perceptions of differences between individual currencies' quality and standing. Both coherent monetary management and convincing evidence of an effective co-ordination of non-monetary policies will be crucial in dispelling such doubts over time.

7. The successful functioning of a monetary union in which national currencies co-exist has far-reaching implications for the formulation and execution of monetary policy in the Community. The adoption of permanently fixed exchange rates in an environment of free and fully integrated capital and money markets generates the need for a single monetary policy carried out through new operational procedures and not simply through the co-ordination of as many national monetary policies as there are currencies participating in the union. This, in turn, requires the attribution of the responsibility for monetary policy to a new institution (the principal features of which are outlined in Section 4), which will not only form the basis for centralised and collective decisions on the expansion of money and credit in the Community, but will also possess the necessary financial attributes (i.e. its own balance sheet) and the regulatory powers to enforce implementation of the chosen policy. One possibility for managing a common monetary policy might be to employ the official ECU as a common

reserve instrument which, firmly controlled by a central monetary institution, would determine the scope for national monetary expansion in line with the Community's monetary policy stance. [Could another possibility be for one of the existing national currencies to be chosen as the anchor of the System and managed collectively in the framework of the European System of Central Banks?]

This shift from national monetary policies to a single monetary policy is an inescapable consequence of entering a monetary union and marks one of the principal institutional changes required by economic and monetary union. In practice, however, the incision will not be so deep but rather will represent the completion of a progressively intensified co-ordination of national monetary policies, which had in many respects already foreshadowed the move to a single monetary policy in the Community. Even prior to the decision to fix exchange rates permanently, the liberalisation of capital movements and financial market integration will have created a situation in which the conduct of a completely autonomous monetary policy at the national level has been rendered much more difficult. Once every banking institution in the Community is free to accept deposits from and grant loans to any customer in the Community and in any of the national currencies, the large degree of territorial coincidence between the national central banks' area of jurisdiction, the area in which their currency is used and the area in which "their" banking system operates will be lost and it will only be possible for monetary policies to be effective if they are merged into a single mould.

8. The decision to lock exchange rate parities between national currencies irrevocably will have profound effects on the functioning and the performance of the economy of the Community.

A monetary union will remove exchange rate uncertainties and lower costs of transactions between residents of different countries in the Community. This will provide a stimulus to intra-Community trade and contribute to a more efficient allocation of resources, and thereby raise the level of economic activity and employment in the Community. At the same time, movements of exchange rates unwarranted by fundamental factors can no longer be a source of macro-economic disturbances and competitive distortions. Moreover, once the locking of exchange rates has gained credibility in the market place, firms and households in all countries are

likely to behave more conformably and will thereby contribute to the evolution of a more homogeneous economic structure in the Community. Finally, the creation of a single currency area in combination with an unrestricted common market will mean that the Community will be much less susceptible to external shocks.

The most serious problem posed by a monetary union is that the exchange rate can no longer serve as an instrument for adjusting economic imbalances among member countries. To the extent that market mechanisms do not perform an adequate equilibrating role, other policies, such as income, fiscal and structural policies, will have to be used more intensively to bring about the corrections in cost and price trends that used to be obtained from time to time by realignments of exchange rate parities. For this reason the implementation of a monetary union must be accompanied by parallel progress in creating or strengthening effective alternative adjustment mechanisms, such as those discussed in the next section. Moreover, while the freezing of exchange rate relationships will not eliminate the possibility of imbalances between the supply of and demand for economic resources in individual Community countries, the statistical measurement and the economic interpretation of such imbalances may become more difficult in a fully integrated market since balance-of-payments disequilibria would essentially assume the meaning of regional imbalances. As a consequence, balance-of-payments figures, which are currently a highly visible and sensitive indicator of economic disequilibria, would no longer be able to play a significant role as guidepost for policy-making. Moreover, with parities irrevocably fixed, foreign exchange markets would cease to provide a source of pressure for policy corrections when economic disequilibria developed and persisted. However, the balance between the economic benefits and costs of exchange rate fixity will become more and more favourable as the Community develops into an optimum currency area. In order to tilt the balance in this direction it is essential that the move towards monetary union should be coupled with measures designed to strengthen the mobility of factors of production and a close co-ordination of non-monetary policies.

9. In summary, the realisation of a monetary union means that in a situation of free capital movements and full financial integration the exchange rates between Community currencies are irreversibly fixed. This

will create a monetary union in which, at least initially, all national currencies circulate freely, although they might eventually be replaced by the ECU as the sole Community currency. The transition from a situation of fixed but adjustable exchange rates to a system of permanently locked parities implies a fundamental change in the economic management of the Community. National monetary policies will have to give way to a single monetary policy for the Community as a whole, formulated and executed jointly in the context of a European System of Central Banks. At the same time, a single currency area implies the abandonment of the exchange rate as an instrument of adjustment of imbalances among Community countries and therefore requires, in parallel to the process of monetary integration, measures to co-ordinate effectively policies in non-monetary areas.

3. The principal features of economic union

10. The definition of economic union is less straightforward than that of monetary union. It certainly comprises the complete freedom of movement of persons, goods, services and capital, and it also includes a certain amount of public functions carried out through regulation, taxation and expenditure. The scope of these functions, however, as well as their distribution between central and local governments, varies from country to country and has evolved historically. This is why, in defining the essential elements of economic union, the Community should be guided by two basic criteria: consistency with the principles that define the economic order of the Community countries, and a guarantee of appropriate balance between the economic and the monetary components of the union.

As regards the first criterion, beyond the differences that may exist between member countries or - within the same country - in different political periods, the distinctive common feature of economic systems in Europe is the combination of a large degree of freedom for market behaviour and private economic initiative with public intervention in the provision of certain social services and public goods. Within this broad conception, the scope for attributing to the Community economic functions that are at present exercised at national levels is limited by adherence to the principle of subsidiarity and by the fact that certain fundamental functions are at present exercised at the national level.

As for the second criterion, a balance between the economic and the monetary components of the union is essential because of the close interdependence between real and monetary developments and the strong interactions between economic and monetary measures. As a consequence, there is a need for common policies effected at the Community level and for close co-ordination of national policies. Without a coherent set of non-monetary policies at the Community and national levels it would be impossible to maintain permanently fixed exchange rates between Community currencies; conversely, without a monetary policy in support of a single currency area, the Community would not be able to develop into a full economic union.

The creation of a single market in Europe, which constitutes a major component of economic union, will impart strong impulses to economic growth and increase economic welfare through both a further specialisation in line with countries' and regions' comparative advantages and the exploitation of economies of scale in production, research and marketing. These gains will materialise as the residents in the enlarged market without internal frontiers respond to price, wage and interest rate movements, which, transmitted throughout the Community, will provide important incentives for a more efficient use of economic resources. There is no doubt that this process will stimulate economic activity and employment in the Community as a whole, and will generate greater economic freedom and increased trade in goods and services.

11. In a situation of irrevocably locked exchange rates this process will benefit from a monetary environment of greater certainty, but - as previous historical experience shows - it will also encounter certain economic risks. This is because the process of adjustment and restructuring set in motion by the removal of physical, technological and regulatory barriers is unlikely to run smoothly or always produce satisfactory results within reasonable periods of time, while exchange rate realignments will not be available as an instrument in support of adjustment. Moreover, economic imbalances emanating from labour and other cost developments in one member country, external shocks with differing repercussions on individual economies, or divergent non-monetary policies pursued at national levels cannot be corrected by exchange rate changes but, as pointed out in the previous section, will have to be eliminated largely by

other policy measures. Only if such imbalances can be reduced rather quickly or their emergence be avoided altogether will it be possible to reap the benefits of economic union without undue costs in the form of marked pressures on output and employment in certain regions of the Community.

12. It is primarily for these reasons that the creation of an economic union requires action in three interrelated areas: measures to create a larger market without internal frontiers and to strengthen its functioning; common policies to enhance the process of resource allocation in those economic sectors and geographical areas where the working of market forces needs to be reinforced or complemented; arrangements which make it possible both to limit the scope for macro-economic divergences between member countries and to design an overall economic policy framework for the Community as a whole.

13. The measures aimed at creating and strengthening the market are to a large extent envisaged in the EC Treaty and the Single Act establishing, by 1992, a single market without internal frontiers. The creation of this market presupposes a "level playing-field" for all residents of the Community, which allows them to make decisions on production, investment and consumption in broadly similar conditions and on the basis of similar levels of information. To this end all barriers which tend to separate markets along national borders have to be eliminated. In particular, all technical and regulatory obstacles have to be removed, norms have to be harmonised or mutually recognised, and certain common minimum standards governing social policy and consumer and environmental protection have to be agreed. Moreover, tax treatment must not discriminate in favour of or against economic activities across Community countries. At the same time, competition policy - conducted at the Community level - has to operate in such a way that access to markets is not impeded and market functioning not distorted by the behaviour of private or public economic agents.

In addition to clearly formulated policies for the dismantling of barriers and the prevention of restrictive practices, efforts may also have to be made to encourage the adoption by all countries of wage-setting

procedures based on productivity developments and to strengthen the regional and occupational mobility of labour.

14. Community policies to complement the single market are necessary because, even in a large economic space without internal frontiers, market forces cannot be expected to lead, on their own, to an optimal allocation of resources and a balanced distribution of wealth throughout the Community. Such policies are needed in a wide range of areas, such as agriculture, transport, research and technological development, environment and, in particular, regional and structural development. Unless the move to economic and monetary union is postponed until a distant date at which all Community countries have reached a broadly similar stage of development, the creation of a single market and the locking of exchange rates will take place in a situation in which owing to ill-adapted structures and differences in productivity, some major regional disparities will exist. The impact of economic and monetary integration on these disparities is difficult to assess: on the one hand, transport costs and economies of scale would tend to favour a shift in economic activity away from less developed regions, especially at the periphery of the Community, to the highly developed areas in its centre, and could therefore produce undue economic and political tensions arising from possible dislocations of industries and labour forces. On the other hand, however, economic integration would also provide less developed regions with lower wage levels a unique opportunity to attract modern and rapidly growing service and manufacturing industries for which the choice of location is much less determined by transport costs and market proximity. In order to encourage and guide the necessary structural adjustment which will help the Community's poorer regions to catch up with the wealthier ones, the Community must develop an effective policy and be endowed with adequate financial resources which will allow it to assist regional development efforts undertaken at national levels.

An important step in this direction was taken in February 1988 with the decision to enlarge considerably the resources of the Community's structural funds and to reorganise structural policies. The principal objective of these policies would not be to subsidise incomes and simply temper inequalities in standards of living but to help to equalise the conditions for production through investment programmes in such areas as

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physical infrastructure, communication, transportation and education. The success of these policies hinges not only on the size of the available financial resources, but to a decisive extent also on the effectiveness of the investment programmes. Indeed, the more recent experience of countries inside and outside the Community has shown that structural and regional development programmes are particularly successful when improvements in the resource base of regions encouraged by investment in infrastructure and education are reinforced by decentralised initiatives for local entrepreneurship, modernisation of urban areas and local institutional arrangements favouring development. It is precisely in this respect that the Community's structural policies have been revised. A longer-term approach in this area will offer countries with lower levels of productivity an appropriate period of transition and in this sense constitutes an essential element of the policy mix to ensure continuing economic integration and the attainment of economic and monetary union.

Furthermore, as long as wage flexibility and labour mobility have not increased considerably, changes in competitiveness in different regions of the Community could lead to relatively large declines in output and employment in areas with deteriorating competitiveness. In order to ease adjustment burdens temporarily, it might be necessary in certain circumstances to organise financing flows through official channels. Such financial support would be additional to what may be provided by spontaneous capital flows and should prompt the recipient to intensify rather than delay economic adjustment. It would therefore have to play a role similar to that of conditional balance-of-payments assistance available under present monetary arrangements.

15. Macro-economic developments are the third area in which action is required. While policies to ensure a proper distributional and allocative functioning of the market without frontiers will have to be formulated and, in part, executed at the Community level, many of the developments on which macro-economic conditions depend will continue to be determined by factors and decisions operating at the national level. This applies not only to wage negotiations and other market-determined behaviour, but in particular also to budgetary policies. Apart from the relatively small Community budget, such policies will necessarily remain the preserve of member states even at the final stage of economic and monetary union, unless the decision

was taken that major public goods constituting the bulk of public sector activity (internal and external security, justice, social security, environment) should to a large extent be provided at the Community level, thereby significantly enlarging the Community budget. In any event, adherence to the principle of subsidiarity implies that Community competence be kept to a minimum.

However, with budgetary and other relevant decisions being taken at national levels, an economic and monetary union can only operate on the basis of mutually consistent and prudent behaviour by governments, unions and other economic agents in all member countries. In particular, unco-ordinated and divergent national budgetary policies might not only undermine monetary stability, but would also generate imbalances in the real and financial sectors of the Community and render it difficult, if not impossible, to pursue appropriate macro-economic policies for the Community as a whole. This is why all countries will have to accept that sharing a common market and a single currency area imposes narrow constraints on their national budgetary policies and requires strict fiscal discipline. Similarly, strong divergences in wage levels not justified by different trends in productivity would produce economic and monetary tensions.

To some extent market forces will exert a disciplinary influence because financial markets, consumers and investors will respond to differences in macro-economic developments in individual countries and regions, assess the budgetary and financial position of different countries, penalise excessively expansionary fiscal behaviour or wage settlements, and thus exert pressure for sounder policies. However, experience suggests that market perceptions do not necessarily provide strong and compelling signals. In particular, in the financial field, rather than leading to a gradual adaptation of borrowing costs, market views about the creditworthiness of official borrowers tend to change abruptly and result in the closure of access to market financing. The constraints imposed by market forces may either be too slow and weak or too sudden and disruptive. For this reason an economic and monetary union requires arrangements which effectively ensure a close and flexible co-ordination of national fiscal policies.

In the macro-economic area, therefore, the aim must be to set up arrangements which will enable the Community to monitor its overall economic situation, to assess its consistency with regard both to

individual countries and to common objectives, and to formulate guidelines for policy. This is particularly important for fiscal and budgetary policies, where arrangements are required which will effectively limit the scope for budget deficits that can be incurred by individual member countries of the Community. Safeguards in this respect will have to include (in accordance with the criteria laid down for a European System of Central Banks) strict limits on the maximum permissible access to monetary financing, as well as on borrowing in non-Community currencies. In addition, agreement must be reached on a system of rules which limits the maximum size of national budget deficits. Finally, co-ordination arrangements in the fiscal field must enable the Community to conduct a coherent mix of fiscal and monetary policies, i.e. to dispose of a system of rules that can be applied with a view to determining the aggregate balance on national budgetary positions, including that of the Community.

16. In summary, the establishment of an economic union implies:

- the creation of an internal market without physical, regulatory or fiscal frontiers, supplemented by a competition policy which effectively removes distortions in competition;
- common policies in transport, research and technological development, and regional and structural development which will help to exploit the full potential of the single market and its role in the allocation of resources, but which will also help regions with lower productivity to catch up with the richer parts of the Community;
- a framework for monitoring and co-ordinating general macro-economic developments in the Community with a view to attaining non-inflationary, balanced economic growth;
- rules setting maximum possible deficits for national budgets and strict limits on both monetary financing and borrowing in third currencies;
- effective procedures for the co-ordination of national budgetary policies to avoid undesirable repercussions on monetary policy.

These requirements not only have to be met in order to derive the greatest possible benefit from an enlarged economic space, they are also indispensable for the cohesion of the monetary union.

4. Institutional arrangements

17. Management of the economic and monetary union therefore calls for an institutional framework which will allow policy to be decided and executed at the Community level in those economic areas that are of direct relevance for the functioning of the union. The institutional framework should guarantee efficient economic management, properly embedded in the democratic process. The creation of a monetary union necessitates the setting-up of a new monetary institution, placed in the constellation of Community institutions (European Council, Council of Ministers, European Parliament, Commission and Court of Justice). The establishment of economic union does not require the creation of a new institution, but the formulation and implementation of common policies in non-monetary fields and the co-ordination of policies under the competence of national authorities, require a revision and, possibly, some restructuring of existing Community institutions.

18. The need for a new monetary institution arises because a single monetary policy cannot be decided and implemented independently by different central banks and because decisions concerning day-to-day monetary policy operations must be centralised if they are to respond quickly to changing market conditions. For these reasons the Community's domestic and international monetary policy must be organised in a European System of Central Banks (ESCB). The System could consist of a central institution, with its own balance sheet, and national central banks. At the final stage the ESCB - acting through its Council - would be responsible for formulating the thrust of monetary policy and managing the Community's exchange rate vis-à-vis third currencies. The day-to-day operations conducted at the Community level, possibly involving changes in interest rates and the use of other policy instruments, would be carried out under the responsibility of the Board of the central institution, supported by its own staff. The national central banks would be entrusted with the

implementation of policies at the regional level in accordance with guidelines established by the Council.

The European System of Central Banks, which would embody the Community's monetary order, should rest on the following basic principles:

Structure and organisation

- a federative structure, since this corresponds best to the political structure of the Community (e.g. a European Central Bank Council representing all the central banks in the union);
- a centralised body (Board with its supporting staff) responsible for the implementation of Council decisions as far as they apply at Community level;
- appointment of members of the Board for relatively long periods on an irrevocable basis;

Mandate and functions

[- the mandate of the System must be to maintain the stability of money as the prime objective of the Community's monetary policy. While fulfilling this task, the System has to support the general economic policy of the Community. Stability of the currency in terms of prices must take precedence over exchange rate stability;

- the System will be responsible for the formulation of monetary policy at the Community level, for the co-ordination of policy implementation at the regional level and for the maintenance of a properly functioning payment system;]

or, alternatively

- [- a commitment to regulate the amount of money in circulation and of credit supplied by banks and other financial institutions on the basis of criteria designed to ensure non-inflationary economic growth as well as to maintain a properly functioning payment system;]
- the System will be responsible for the formulation of banking supervisory policy at the Community level and co-ordination of banking supervision policies of the national supervisory authorities;

- national central banks remain responsible for policy implementation at the regional level;

#### Status

- independence of instructions from national governments and Community authorities;
- a proper democratic legitimisation which might be achieved through regular reporting to [a committee of the European Parliament and the Council of Ministers] and through [the European Parliament and the Council of Ministers] participating in the appointment of the members of the Board;
- supervision of the administration of the System independently of the Community bodies, for example by a supervisory council or a committee of independent auditors;
- submission of an annual report by the ESCB to the Council of Ministers and the European Parliament;

#### Policy instruments

- the instruments available to the System will be specified in its statute, together with a procedure for amending them; the instruments will comprise both regulatory powers and the authority to conduct central banking operations in money and foreign exchange markets;
- strict limitation of lending to all public authorities;
- monetary policy instruments oriented towards a free market economy;

#### Seat of the institution

- to be decided.

19. The institutional requirements for effective conduct of economic policies should be assessed in the light of the functions which will be performed at the Community level. As noted in the previous section, there are three broad areas in which the Community has to be involved: firstly, the establishment and maintenance of a single market for persons, goods, services and capital; secondly, the formulation and implementation of

common policies aimed at strengthening and balancing the process of market integration; and thirdly, co-ordination of macro-economic policies, in particular with a view to promoting prudent fiscal behaviour, avoiding inappropriate divergences between national fiscal policies and formulating a macro-fiscal policy stance of the Community.

The necessary institutional framework for performing these three tasks is already in place with different, though partly overlapping, functions conferred on the Council, the European Parliament, the Commission and the Court of Justice. In order to ensure a flexible and effective conduct of policies in those economic areas in which the Community is involved, two basic requirements have to be fulfilled: firstly, to the extent that policies are decided and enacted at the Community level, there must be a clear distribution of responsibilities among the existing Community institutions, with due regard to whether decisions relate to the setting of broad policy directions or to day-to-day operations in the light of current developments. Secondly, in those areas in which the Community's role is restricted to the co-ordination of national policies, its task must be guided by a system of rules which are accepted by, and can be applied to, individual member states. By analogy with the structure of the European System of Central Banks, where the ESCB Council would determine the broad lines of monetary policy and the day-to-day execution of these policies would be in the hands of the Board, a similar allocation of responsibilities between the Council of Ministers and the Commission could be envisaged in the economic field.

In order to be able to carry out their functions within the existing institutional framework, the Community bodies must possess adequate instruments and means. As far as the implementation of the single market is concerned, the necessary procedures and arrangements have been laid down in the Treaty of Rome and the Single Act, conferring upon the Community the legislative, executive and judicial authority to put the internal market programme into effect.

With regard to common policies aimed at strengthening the functioning of the single market, the foundations for a more effective Community role in regional and structural policies have recently been put in place, involving both a doubling of the resources of structural funds and a reorganisation of policies. At a more advanced stage of the process these mechanisms might be further extended and made more effective.

In order to enable the Community to pursue an appropriate macro-economic policy, new procedures, taking due account of the basic principle of subsidiarity, will have to be developed. This applies particularly to the area of public revenue and expenditure where competences will be mixed, with the bulk of the budgetary decisions being made at national level and Community budgetary decisions being confined to the limited expenditures and revenues required for the purpose of common policies. These procedures must define and maintain a fair balance between co-ordination through rules fixing a set of objectives and constraints and discretionary co-ordination adapted to a particular economic situation. This implies a need for both horizontal co-ordination - between member countries and the Commission and the Council - and vertical co-ordination between a member country and the Commission.

The objective of the co-ordination of macro-economic policies is to determine a strategy for growth and employment in an environment of price stability and economic cohesion. For this purpose co-ordination must aim at: defining medium and short-term policy approaches, bearing in mind all their economic and social implications; setting a multi-year framework for national and Community budgetary policies; managing common policies, particularly with a view to improving economic and social cohesion; and determining, in close consultation with the ESCB Council, the Community's exchange rate policy.

The most difficult and most important task in this context is to develop a credible procedure for joint decision-making on the overall stance of fiscal policy, i.e. the size and the financing of the aggregate budgetary position in the Community. In this context the Community must be given the possibility of directly influencing the budgetary policies of individual member countries through a system of rules and by collective decisions. However, given the fact that the ultimate budgetary decision-making power will rest with national parliaments, the system of rules can serve essentially only as a framework for increasing the transparency of the co-ordination process, which, for example through public announcement of limits on budgetary positions, could help to exert greater peer pressure.

While the involvement of the Community in non-monetary policies will be based on the existing institutional setting, it is of paramount importance that the ensuing policy decisions should result in a coherent



and consistent set of measures which clearly signal the Community's policy stance. Without an unequivocal formulation of non-monetary policies, in particular in the fiscal field, the responsibility for macro-economic policy for the Community as a whole would fall virtually entirely to the European System of Central Banks. This would not only cede too great a responsibility to the monetary authorities, it would also leave the Community with only one macro-economic policy tool and therefore significantly impede an effective policy geared to stability and growth.

20. The new Treaty laying down the programme, procedures and organs of the economic and monetary union will create a situation in which the existing Community institutions (European Council, Council of Ministers, European Parliament, Commission, and Court of Justice) will be supplemented by a new institution of comparable status, the European System of Central Banks. Relationships and interactions between these bodies will have to be defined not only in order to construct a consistent institutional framework, but also to ensure an effective procedure of consultation and co-ordination between fiscal and monetary policies. To this end appropriate and regular relations between the existing institutions and the European System of Central Banks must be established which provide for consistent consultation procedures without, however, impinging on the policy responsibilities entrusted to each institution in its own field of economic and monetary management. Such consultation procedures could include participation by the President of the Council and the President of the Commission in meetings of the ESCB Council, and participation by the Chairman of the ESCB Council in meetings of the Council of Ministers. Moreover, the involvement of the European Parliament and national parliaments in the co-ordination process should be strengthened and the European Parliament should be consulted in advance on the stance of economic policy in the Community. The consultation process should include a yearly joint assessment of the overall economic and monetary situation and prospects, and the formulation of a general policy guideline for the year to come. Moreover, the Council of Ministers and the Commission would submit a report each year to the European Council and the European Parliament on the functioning and the status of the economic and monetary union.

22nd December 1988

E CCOOP  
B. I. S.

Note to the members of the Committee

Please find enclosed a copy of the revised Part III of the Skeleton of the final report. It is circulated for discussion at the Committee's next meeting on 10th January 1989.

In agreement with the Chairman the following changes have been made in comparison with the previous draft (CSEMU/5/88 of 9th December 1988):

- removal of the section on "The role of the ECU", in consideration of the fact that the issues relating to a parallel currency and the ECU will be discussed in January on the basis of papers distributed by members of the Committee. The passage of the report dealing with the role of the ECU will be redrafted in the light of this discussion;
- insertion of a section on "The Treaty" (which incorporates the part on "How to proceed" previously contained in Part II.5 of the Skeleton), in accordance with the wish expressed by the Committee to deal with these issues in Part III of the report;
- incorporation of drafting suggestions made by Governor de Larosière concerning his proposal on a European Reserve Fund;
- various editorial amendments;
- preparation of an Annex containing a synopsis of Scenarios A and B.

Gunter D. Baer

Tommaso Padoa-Schioppa

B. I. S.

Insist on having as representative.

### III. Concrete steps towards economic and monetary union

#### 1. Principles governing a step-by-step approach

The request made by the European Council to the Committee to study "concrete steps" reflects the awareness that an economic and monetary union, as outlined in Part II of this Report, is too profound a change in the economic and institutional structure of the Community to be realised at one stroke. Households, corporations, unions and public administrations will need time to adapt their economic behaviour to a new setting. Similarly, it will not be possible to attribute new powers to the Community at once in all fields. Rather, it will be necessary to build on success and to retain the possibility of correcting the course of action in the light of new experiences.

The ambition, but also the complexity, of the final objective of economic and monetary union reinforce the need to define clearly the process which is to lead to European economic and monetary unification. The present diversity in the situations of the different European countries and the variety of areas involved - which go well beyond the economic and monetary sphere - make it necessary to be both clear and precise concerning the path to be mapped out.

The Committee is of the view that, in addition to the general principle of subsidiary explained earlier in this Report, a number of considerations have to be taken into account in designing a step-by-step approach to economic and monetary union.

##### (a) Discrete but evolutionary steps

The process of implementing economic and monetary union will have to be divided into a limited number of clearly defined stages. Each stage will have to represent a significant change with respect to the

preceding one. New arrangements coming into force at the beginning of each stage will gradually develop their effects and bring about a change in economic reality so as to pave the way for the next stage. This evolutionary development within each stage will apply to both functional and institutional arrangements.

(b) Parallelism

Parallel advancement in many interrelated areas is an indispensable prerequisite for the avoidance of imbalances which could cause economic strains and loss of political support for the continuing process of developing the Community into an economic and monetary union. Perfect parallelism, however, at each and every point of time is impossible and could even be counterproductive. Already in the past the advancement of the Community in certain areas has been combined with temporary standstill in others, thus involving a process of only partial parallelism. A certain amount of temporary deviations from parallelism is part of the dynamic evolutionary process of the Community. However, parallelism has to be maintained in the medium term.

(c) Calendar

The Committee considers that the conditions for moving from stage to stage cannot be defined in advance. They depend on too many factors to permit the announcement of explicit deadlines. The timing of, especially, the move to irrevocably fixed exchange rates will have to be judged in the light of circumstances by those responsible, including the Centre for Economic Policy Co-ordination (CEPC) and the European System of Central Banks (ESCB), which will have been created in the second stage. A clear commitment to the final stage, as described in Part II, is however indispensable. There should be a clear indication of the timing of the first step. It should begin when the Directive for the full liberalisation of capital movements comes into force, and there should be a presumption that it will not last beyond the end of 1992.

(d) Indivisibility and gradualism

As has been said above, progress should be both evolutionary and step-by-step. There has to be a balance between the need to make significant steps and the need for gradualism. In achieving this balance it should be recognised that in certain specific areas the ultimate

responsibility for given policy decisions, if not operational duties, has to be clearly defined. Unless it is unmistakable who (i.e. whether national governments or the Community; which organ or institution) has "the last word", there is a risk of market uncertainty and policy conflict.

(e) Participation

There is one Community, but not all the members have participated fully in all its aspects from the beginning. So far this has mainly been the consequence of successive enlargements and, for the EMS, of the decision of some countries not to join the exchange rate agreement. A consensus on the final objectives of the Community, as well as participation in the same set of institutions, should be maintained, while allowing for a degree of flexibility concerning the date on which some member countries join certain arrangements. The management of each set of arrangements should be the responsibility of those who fully participate in it.

2. Two scenarios in three steps

What follows are two scenarios based on the above principles. Each has three distinct steps towards economic and monetary union.

There are many similarities between the two scenarios. In both scenarios:

- (i) each stage represents a significant change with respect to the preceding one, and allows for functional and institutional developments within each stage;
- (ii) there are parallel developments on the economic and monetary sides;
- (iii) no precise calendar is given for moving from step to step, but in both cases stage one would begin with the coming into force of the Directive for the full liberalisation of capital movements;

- (iv) step three would include the passing of the definitive "gate" of the "irrevocable locking of parties", which in turn implies the coming into force of a monetary regime in which the responsibility to ensure price stability is exerted jointly through the ESCB. A parallel movement would have to be made on the economic side with an increased role for the CEPC.

The essential differences between the two scenarios primarily concerns step one, in which they take varying views on the questions of (a) indivisibility and gradualism; and (b) participation.

a. Indivisibility and gradualism

Scenario A unambiguously leaves in national hands the full responsibility for monetary decision-making in the first phase. There would be an upgrading of the procedures for policy-co-ordination both in the economic and monetary areas, but the new procedures would not be binding and no change would have to be made in either the Treaty of Rome or in national legislation. Changes in secondary Community legislation would be sufficient.

In scenario B on the other hand, although the responsibility for policy decisions would remain wholly in national hands, the first stage would include from the outset the creation of a European Reserve Fund (ERF). It would have some monetary policy instruments available to it; and would be a training ground for the conduct and formulation of the unique European monetary policy.

b. Participation

While shaped for the specific needs of the exchange rate mechanism of the EMS the first step of scenario A would be consistent with participation of all Member States of the Community. In contrast, in scenario B only those countries which fully participate in the exchange rate mechanism of the EMS would participate in the ERF.

These differences in the first stage of each scenario would entail some slight differences in their second stages. In particular, the second stage of scenario B would include the unwinding of the ERF and its absorption in the ESCB.

Both scenarios see scope for immediate and meaningful measures in both the economic and monetary areas. An important question is whether these should involve immediately some changes in national legislation. It may be thought that the political and institutional debate that would inevitably accompany any act to be taken by national parliaments should be reserved for the "big change" of a new Treaty rather than for an initial step only. On the other hand, it may be considered that this is too constraining and that immediate moves to create an embryo monetary institution should be made, even if these would require changes in national legislation.

Amongst the justifications for a more substantial first step are the following three observations.

- The creation by 1992 of a single European market for capital transactions and financial services is an irreversible process in which European countries have engaged and which requires central banks of countries participating in the EMS to improve monetary policy co-ordination at both internal and external levels.
- The sizable fluctuations within the international monetary system have led central banks to rely more heavily on intervention in the foreign exchange markets on a co-ordinated basis. However, such a policy necessarily has a direct influence on the implementation of domestic monetary policies in these countries. It is therefore necessary and urgent that central banks create means for analysing such issues on a permanent and common basis. It is not only a matter of strengthening the impact of their operations, but also of maintaining the efficiency of their monetary management both at domestic and European levels.

- The tendency of the European central banks to conduct their monetary policies on the basis of differentials vis-à-vis other countries is not necessarily conducive to fostering a monetary policy satisfactory for the Community as a whole. The creation of a common monetary think-tank for analysis and recommendations would make it possible to address this problem better. The deliberations within this monetary think-tank would in effect provide all the central banks with a better basis for setting their own national approaches in a European context while preserving full decision-making autonomy.

### 3. The Treaty

The implementation of economic and monetary union must, as specified in Article 102A of the Treaty, be embodied in a new Treaty. The first step of both scenario A and B could be implemented without a new Treaty. This would however be required for moving from step one to step two.

One procedure would be to conclude a new Treaty each time a political consensus to advance one step has been reached. The advantage of this procedure is that it clearly lays open at each step the political commitment. Its disadvantage is that, as well as being unwieldy and slow, the overall consistency of the process may not be sufficiently safeguarded and sight may be lost of the ultimate objective. It also carries the risk that progress in parallel between the monetary and non-monetary sides would not be respected.

The Committee is therefore in favour of concluding a single comprehensive Treaty which would formulate clearly the essential features and institutional arrangements of economic and monetary union and the steps in which it can be achieved.

The Treaty would facilitate the implementation process through the provision of "organic laws" and enabling clauses and would indicate the procedures by which the decision will be taken to move from stage to stage. Each move would require an appraisal of the situation and [unanimous] political agreement. [Should unanimity be adopted as the rule for all the



stages? Who should participate in the decision? The European Council may have to take the final decision, but what say will the organs of the economic institution and monetary institution respectively have in proposing, or giving advice on, the decision?]

4. Scenario A

A(1) Stage one

(to be enacted in conjunction with the coming into force of the directive on short-term capital movements.)

In the institutional field:

- preparation and ratification of the Treaty on the economic and monetary union, with a procedure similar to the one followed for the Single European Act.

In the economic field:

- complete removal of internal barriers and liberalisation of exchanges of goods, services and capital within the Community, according to the single market programme adopted in the Single Act; strengthening of Community competition policy and of the executive and judiciary authority to identify and sanction infringements of Community law;
- full implementation of the "Brussels package" for reforming and doubling the structural funds, designed to strengthen substantially the ability of Community policies to promote regional development and to correct economic imbalances;
- replacement of the 1974 Council Decision on economic convergence by a new procedure for an increasing degree of budgetary policy co-ordination. The thrust of the revision of the 1974 convergence decision will be to strengthen considerably the possibilities for reducing fiscal imbalances, as well as for improving the assessment of the

overall policies of the Member States in the light of both their economic and social consequences and their consistency. The assessment will form the basis for a more effective co-ordination of macro-economic policies, with co-ordination being based on recommendations and carried out with due account of the views of the Committee of Governors. In particular, the revised 1974 convergence decision will:

- set up a new procedure for budgetary policy co-ordination, with increasingly precise quantitative guidelines, where appropriate, and medium-term orientations; and a programme for member countries concerned to consolidate their budgetary position [by reducing, where necessary, the central government deficit to no more than X% of GNP over a period of Y years].
- establish a process of multilateral surveillance of economic performance and policies based on macro-economic indicators. Where developments are judged inadequate or detrimental to commonly set objectives, these would trigger at the Community level recommendations and endorsements to correct national policies;
- provide for the possibility of promoting, where felt appropriate, concerted actions of the member countries;

In the monetary field:

- capital transactions: the coming into force of the June 1988 directive liberalising monetary movements in July 1990 will establish a regime of complete freedom of capital transactions. During this first stage measures will be taken to deal with both the problem of fiscal evasion caused by the full liberalisation of capital movements and discriminatory measures which risk distorting capital flows;
- policy co-ordination: the 1964 Council Decision defining the mandate of the Committee of Central Bank Governors would be

replaced by a new decision giving the Committee greater authority and visibility and making it the forerunner of the Council of the European system of central banks to be created under the new Treaty. The thrust of the revision of the 1964 Council Decision will be to encourage a strengthening of the co-ordination of monetary policy among all member countries of the Community. To this end, the Committee will be invited to:

- formulate recommendations on the overall orientation of monetary and exchange rate policy, as well as on measures taken in these fields by individual countries. In particular, the Committee would be consulted in advance of national decisions on the course of monetary policy, such as the setting of annual domestic monetary and credit targets;
- make policy recommendations to individual governments and the Council of Ministers on non-monetary policies that could affect the internal and external monetary situation in the Community, especially the functioning of the EMS. The outcome of the Committee's deliberations could be made public;
- submit an annual report on its activities and the monetary situation of the Community to the European Parliament;
- set up a sub-committee to start regular consultations concerning matters of common interest in the field of banking supervision.

In order to enhance its role in the process of monetary policy co-ordination:

- the Committee's opinions and recommendations would not have to reflect unanimity, but could be established by a qualified majority [determined on the basis of weighted votes?]; the recommendations would not be binding;

- the Committee would be chaired by a Chairman who would be elected for a period of [three] years;
  - the Committee would be supported by a permanent Secretariat.
- 
- EMS arrangements: all member countries [in a position to do so] would become participants in the exchange rate mechanism of the EMS with the same fluctuation margins; [the very short-term and the short-term financing mechanisms would be strengthened to make the system better equipped to counter, if needed, destabilising short-term capital movements;] margins of fluctuation would be narrowed from 2.25 to [1]%;
  - ECU arrangements: removal of regulatory impediments that may prevent market participants using the ECU in setting prices, keeping corporate accounts, and contracting and settling any kind of pecuniary obligations. The ECU remains a basket.

A(2) Stage two

(to be enacted when the new Treaty comes into force.)

In the economic field:

- the Centre for economic policy co-ordination (CEPC) would start operating with a view to promoting convergence and co-ordination of economic policy in the Community. The Centre would be responsible for the:
  - introduction of progressively more precise rules relating to the size of the budget deficits and their financing;
  - adoption of medium-term guidelines for key financial targets and economic programmes in the member states;
  - joint adoption of budgetary objectives, when felt appropriate, as part of a co-ordinated budgetary and economic policy;

- enlargement of resources for supporting the structural policies of the Member States and strengthening the Community investment programmes in the fields of research and infrastructures;
- the Centre would also take a view on the exchange rates of the Community vis-à-vis major third currencies.

In the monetary field:

- creation of the European System of Central Banks (ESCB) described in Part II of this Report, with its decision-making organs (Council and Board), staff, balance sheet, and legal underpinnings: mandate to preserve price stability, independence, accountability, decision-making procedures. The ESCB would replace the present institutional monetary arrangements (EMCF, Committee of Governors and its permanent Secretariat). The ESCB would be initially endowed with a certain proportion of gold and third currencies, previously held as foreign exchange reserves by national central banks, as well as certain contributions of national Community currencies. The initial endowments could be increased over time.

The tasks of the ESCB would be:

- to act as a forum for [binding] ex ante co-ordination of national monetary policy targets, with monetary policy still being conducted by national central banks. The co-ordination would take place in the ESCB Council, which in addition, would take over the functions performed in stage one by the Committee of Governors. The ESCB Council would be supported by a permanent staff (which replaces the permanent Secretariat set up in stage one), and the staff would be supervised by the Board;
- to conduct [limited] exchange market interventions, both in third currencies and within the EMS [in

concertation with central banks whose currencies were used? In accordance with guidelines established by the Council?];

- to represent the Community (together with representatives of national central banks) in international monetary meetings;
- to manage its holdings of third currencies and national Community currencies;
- to administer the short-term and very short-term financing mechanisms;
- to administer the private ECU clearing system;
- [the Chairman of the ESCB Council would attend the ECO/FIN meetings and the ESCB would make an annual report to the European Parliament? the Council?]

[N.B. Owing to the small size of ESCB interventions and to the firm control exercised by its Council (or to the provision to co-ordinate interventions with the national central banks concerned), the impact of these operations on domestic monetary conditions of member countries should be negligible. Its main function would be to provide a signal to the market.]

A(3) Stage three

(The beginning of this final stage would be marked by the definite locking of parities. This should be decided when the economic conditions in the participating countries are judged appropriate. This stage corresponds to the final stage described in Part II. It should be observed that the so-called "final stage" is not necessarily a stage beyond which the system would not be susceptible to further evolution. Rather, it is one in which the fundamental requirements of an economic and monetary union would have been fulfilled, albeit in a setting that might be subject to changes and improvements.)

In the economic field:

The authority of the Centre for economic policy co-ordination would be extended. [Following the programme set out in the new Treaty, legislative and executive measures would be taken, at the Community as well as the national level, leading to the creation of a European Fiscal Framework (EFF). Such a system would cover: essential tax harmonisation; the respective roles of national and Community budgets; "own" resources of the Community budget; the size of budget deficits and their financing;] The Centre would have the authority:

- to impose constraints on national budgets to the extent to which this is necessary to prevent imbalances that may threaten monetary stability;
- to make discretionary changes (through a procedure to be defined) in Community resources to supplement structural transfers to Member States or to influence the overall policy stance in the Community;
- to propose discretionary changes (through a procedure to be defined) in the level of harmonised taxation rates;
- to apply some form of conditionality to existing Community structural policies and to Community loans (as a substitute for the present medium-term loans facility).

In the monetary field:

- announcement of irrevocable fixing of parities between the Community currencies;
- concurrently the full responsibility for the formulation of monetary policy in the Community would be attributed to the ESCB Council, replacing the [binding] ex ante co-ordination procedure followed during the preceding stage;
- decisions on exchange market interventions in third currencies would be made entirely under the responsibility of the ESCB Council in accordance with Community exchange

- rate policy; the execution of interventions would be entrusted to [one or ?] national central bank;
- the implementation of the Community's monetary policy would be carried out by the Board of the ESCB in co-operation with national central banks. In order to be able to influence overall monetary developments in accordance with the decisions of the ESCB Council, the Board would be empowered both to impose and vary minimum reserves [in ECU; national currencies, third currencies?] to be held by national central banks and to operate directly in the money markets and to set lending interest rates.

A(4) Last stage

- the ECU replaces national currencies.

5. Scenario B

B(1) Stage one

(to be enacted in conjunction with the coming into force of the directive on short-term capital movements.)

In the institutional field:

- preparation and ratification of the Treaty on the economic and monetary union, with a procedure similar to the one followed for the Single European Act.

In the economic field:

- complete removal of internal barriers and liberalisation of exchanges of goods, services and capital within the Community, according to the single market programme adopted



in the Single Act; strengthening of Community competition policy and of the executive and judiciary authority to identify and sanction infringements of Community law;

- full implementation of the "Brussels package" for reforming and doubling the structural funds, designed to strengthen substantially the ability of Community policies to promote regional development and to correct economic imbalances;
- replacement of the 1974 Council Decision on economic convergence by a new procedure for an increasing degree of budgetary policy co-ordination. The thrust of the revision of the 1974 convergence decision will be to strengthen considerably the possibilities for reducing fiscal imbalances, as well as for improving the assessment of the overall policies of the Member States in the light of both their economic and social consequences and their consistency. The assessment will form the basis for a more effective co-ordination of macro-economic policies, with co-ordination being based on recommendations and carried out with due account of the views of the Committee of Governors. In particular, the revised 1974 convergence decision will:

- set up a new procedure for budgetary policy co-ordination, with increasingly precise quantitative guidelines, where appropriate, and medium-term orientations; and a programme for member countries concerned to consolidate their budgetary position [by reducing, where necessary, the central government deficit to no more than X% of GNP over a period of Y years];
- establish a process of multilateral surveillance of economic performance and policies based on macro-economic indicators. Where developments are judged inadequate or detrimental to commonly set objectives, these would trigger at the Community level recommendations and endorsements to correct national policies;

- provide for the possibility of promoting, where felt appropriate, concerted actions of the member countries;
- views about exchange rates of major third currencies should be taken within a Community framework.

In the monetary field:

- capital transactions: the coming into force of the June 1988 directive liberalising monetary movements in July 1990 will establish a regime of complete freedom of capital transactions. During this first stage measures will be taken to deal with both the problem of fiscal evasion caused by the full liberalisation of capital movements and discriminatory measures which risk distorting capital flows;
- EMS and policy co-ordination: following the procedure used in 1978 for the creation of the EMS (a Resolution of the European Council followed by an agreement between central banks), and complemented, as appropriate, by changes in national legislation, a reform of EMS arrangements would be implemented along the following lines:
  - creation of a European Reserve Fund, the ERF, [replacing EMCF when all EMS countries are participants] with the task of intervening in third currencies and eventually in Community currencies intramarginally or at the limit in order to supplement individual action when tensions appear. The ERF's intervention should take place after unanimous agreement has been reached between central bank members. Interventions would serve the two purposes of creating a "training ground" and providing a signal effect through concerted interventions;
  - the resources of the ERF will be provided by a pooling of reserves of the participating central banks that would represent initially 10% of their gold holding and 10% of their foreign currency holdings;
  - the ERF would ensure the management of these reserves;

- the ERF would also set up a Monetary Policy Department which would be in charge of analysing in particular interest rate trends, monetary aggregates and domestic demand. It would thereby facilitate from a Community point of view the concerted management of exchange rates and the co-ordination of monetary policies among the different participating central banks;
- this phase could go along with the creation of a monetary policy co-ordination committee, which would define common surveillance instruments, propose harmonised objectives, and would progressively graduate from an ex post analysis to an ex ante approach to monetary policy adjustment;
- all the EEC's central banks would be eligible to join the ERF. However, membership would be subject to their participation in the exchange rate mechanism and the pooling of a portion of their reserves;
- as a forerunner of the future European Central Bank or the European system of central banks, the management of the ERF would consist of:
  - a Board of Directors which would comprise automatically the Governors of each central bank participating in the ERF; [a member of the Commission would attend the Board meetings];
  - an Executive Committee whose members would be selected by the Committee of Governors on the basis of competence. This Executive Committee would be of a small size, consisting of three or four members who would have direct responsibility for the different departments of the ERF;
  - two committees: a Foreign Exchange Policy and a Monetary Policy Committee. They would report regularly to the Committee of Governors and, in the framework of a more active "monitoring", would recommend appropriate action in the field of exchange rates and interest rates;

- two departments: a Foreign Exchange and Reserves Management Department, and a Monetary Policy Department;
  - [Accountability? The President of the Executive Committee would attend the ECO/FIN meetings and the ERF would make an annual report to the European Parliament? the Council?]
- 
- ECU developments: removal of regulatory impediments that may prevent market participants using the ECU in setting prices, keeping corporate accounts, and contracting and settling any kind of pecuniary obligations. The ECU remains a basket.
  - bank supervision: regular consultations concerning matters of common interest in the field of banking supervision are held within [the European Reserve Fund? the Committee of Governors];

B(2) Stage two

(to be enacted when the new Treaty comes into force.)

In the economic field:

- the Centre for economic policy co-ordination (CEPC) would start operating with a view to promoting convergence and co-ordination of economic policy in the Community. The Centre would be responsible for the:
  - introduction of progressively more precise rules relating to the size of the budget deficits and their financing;
  - adoption of medium-term guidelines for key financial targets and economic programmes in the member states;
  - joint adoption of budgetary objectives, when felt appropriate, as part of a co-ordinated budgetary and economic policy;

- enlargement of resources for supporting the structural policies of the Member States and strengthening the Community investment programmes in the fields of research and infrastructures;
- the Centre would also take a view on the exchange rates of the Community vis-à-vis major hard currencies.

In the monetary field:

- creation of the European System of Central Banks (ESCB) described in Part II of this Report, with its decision-making organs (Council and Board), staff, balance sheet, and legal underpinnings: mandate to preserve price stability, independence, accountability, decision-making procedures. The ESCB would replace the pre-existing institutional monetary arrangements (EMCF, ERF, Committee of Governors). The ESCB would take over the claims and liabilities of the ERF, assume its functions and incorporate its institutional features. Apart from the resources taken over from the ERF, the ESCB would also receive certain contributions of national Community currencies. The initial endowments could be increased over time. In addition to the tasks that had already been entrusted to the ERF in the preceding stage, the ESCB would:

- act as a forum for [binding] ex ante co-ordination of national monetary policy targets, with the conduct of monetary policy still being left to national central banks. The co-ordination would take place in the ESCB Council (replacing the Board of Directors of the ERF), which would be supported by an [enlarged] permanent staff (incorporating the departments of the ERF), managed by the Board (replacing the Executive Committee of the ERF);
- conduct [on a larger scale than in the preceding stage] exchange market interventions, both in third currencies and within the EMS, at the discretion of the Board, but

- in accordance with guidelines established by the ESCB Council;
- represent the Community (together with representatives of national central banks) in international monetary meetings;
  - administer the short-term and very short-term financing mechanisms;
  - administer the ECU clearing system;
  - [the Chairman of the ESCB Council would attend the ECO/FIN meetings and the ESCB would make an annual report to the European Parliament? the Council?]

[N.B. Owing to the relatively small size of ESCB interventions and to the firm control exercised by the ESCB Council (or the provision to co-ordinate interventions with the national central banks concerned), the impact of ESCB operations on domestic monetary conditions of member countries should be [rather small, negligible]. Its main function would still be to provide a signal to markets.]

B(3) Stage three:

(The beginning of this final stage would be marked by the definite locking of parities. This should be decided when the economic conditions in the participating countries are judged appropriate. This stage corresponds to the final stage described in Part II. It should be observed that the so-called "final stage" is not necessarily a stage beyond which the system would not be susceptible to further evolution. Rather, it is one in which the fundamental requirements of an economic and monetary union would have been fulfilled, albeit in a setting that might be subject to changes and improvements.)

In the economic field:

The authority of the Centre for economic policy co-ordination would be extended. [Following the programme set out in the new Treaty, legislative and executive measures would be taken, at

the Community as well as the national level, leading to the creation of a European Fiscal Framework (EFF). Such a system would cover: essential tax harmonisation; the respective roles of national and Community budgets; "own" resources of the Community budget; the size of budget deficits and their financing;] The Centre would have the authority:

- to impose constraints on national budgets to the extent to which this is necessary to prevent imbalances that may threaten monetary stability;
- to make discretionary changes (through a procedure to be defined) in Community resources to supplement structural transfers to Member States or to influence the overall policy stance in the Community;
- to propose discretionary changes (through a procedure to be defined) in the level of harmonised taxation rates;
- to apply some form of conditionality to existing Community structural policies and to Community loans (as a substitute for the present medium-term loans facility).

In the monetary field:

- announcement of irrevocable fixing of parities between the Community currencies;
- concurrently the full responsibility for the formulation of monetary policy in the Community would be attributed to the ESCB Council, replacing the [binding] ex ante co-ordination procedure followed during the preceding stage;
- decisions on exchange market interventions in third currencies would be made entirely under the responsibility of the ESCB Council in accordance with Community exchange rate policy; the execution of interventions would be entrusted to [one or ?] national central bank;
- the implementation of the Community's monetary policy would be carried out by the Board in co-operation with national central banks. In order to be able to influence overall monetary developments in accordance with the decisions of

## SCENARIO A

Stage One

comes into force at the same time as the full liberalisation of capital movements. Stage one would not involve any transfer of decision-making authority from the Member States to the Community. Policy co-ordination in both the economic and monetary fields would be strengthened. This would be done in existing fora.

Institutional field

Prepare and ratify a single Treaty on all the steps towards EMU, using a procedure similar to the one followed for the Single European Act.

Economic field

Complete the 1992 internal market programme and strengthen competition policy:

implement accompanying policies and reform of structural funds to promote regional development and correct economic imbalances.

reinforce budget policy co-ordination through reform of the 1974 Convergence Decision to establish:-

- quantitative guidelines and medium-term orientations;
- a process of multilateral surveillance based on macro-economic indicators;
- the possibility of promoting concerted actions.

Monetary field

Complete the programme for the full liberalisation of capital movements.

Replace 1964 Decision defining the mandate for the Committee of Central Bank Governors to give them more authority and visibility. The Committee would:-

- formulate recommendations on monetary and exchange rate policy;
- make policy recommendations on non-monetary policy;
- submit an annual report to the Parliament;
- have a regular subcommittee on banking supervision matters;
- make its decisions by qualified majority;
- have a chairman appointed for [3] years and have a permanent secretariat.

Strengthen the EMS, by enlarging participation [by member countries in a position to do so] and narrowing the fluctuation bands.

Remove regulatory impediments to the use of the ECU.

## SCENARIO B

Stage One

comes into force at the same time as the full liberalisation of capital movements. Stage one would not involve any transfer of decision-making authority from the Member States to the Community. Policy co-ordination in both the economic and monetary fields would be strengthened. A new body, the European Reserve Fund, would be created.

Institutional field

Prepare and ratify a single Treaty on all the steps towards EMU, using a procedure similar to the one followed for the Single European Act.

Economic field

Complete the 1992 internal market programme and strengthen competition policy:

implement accompanying policies and reform of structural funds to promote regional development and correct economic imbalances.

reinforce budget policy co-ordination through reform of the 1974 Convergence Decision to establish:-

- quantitative guidelines and medium-term orientations;
- a process of multilateral surveillance based on macro-economic indicators;
- the possibility of promoting concerted actions.

take a view on the exchange rates of major third currencies

Monetary field

Complete the programme for the full liberalisation of capital movements.

Set up a European Reserve Fund, composed of all Member States fully participating in the ERM.

Tasks:-

- analyse monetary developments, especially interest rate trends, monetary aggregates and domestic demand;
- define common surveillance instruments, propose harmonised objectives and progressively graduate from ex post analysis to an ex ante approach to monetary policy adjustment;
- manage the pooled reserves - 10% of gold and foreign currency holdings;
- intervene on the exchange markets after unanimous agreement between central bank members;
- [make an annual report to the Parliament].

Structure:-

- a Board of Directors comprised of the Governors of all the participating central banks; [a member of the Commission would participate];
- an executive committee of 3-5 members selected by the Board of Governors;
- a foreign exchange policy committee; and a monetary policy committee;
- a small permanent staff.

Remove regulatory impediments to the use of the ECU.

Regular consultations on bank supervision in (the ERF? the Committee of Governors).



## Stage Two

comes into force with the ratification of the Treaty. In stage two, the final word on the conduct of policy remains with the member states. There is however a transfer of some instruments of policy to the Centre but not of sufficient magnitude to overwhelm national policy decisions.

### Economic field

Center for economic policy co-ordination (CEPC)

#### Tasks:-

- the progressive introduction of rules relating to the size and financing of budget deficits;
- adoption of medium-term guidelines for key financial targets and economic programmes in the Member States;
- joint adoption of policy measures, when felt appropriate, as part of a co-ordinated budgetary and economic policy;
- economic management of common policies and enlarged structural funds and strengthening Community investment programmes especially in the fields of research and infrastructure;
- to take a view on the exchange rate vis-à-vis major third currencies and other international monetary matters.

Its structure would be based on that of the existing Community institutions.

### Monetary field

European System of Central Banks (ESCB) consisting of the Council, the Board and the staff and the national central banks.

#### Tasks:-

- act as a forum for [binding] ex ante co-ordination of national monetary policies;
- conduct intervention [in concertation with central banks whose currencies are used? in accordance with guidelines established by the Council?];
- represent the Community in international monetary meetings (together with representatives of National Central Banks);
- administer short and very short financing mechanisms;
- administer the private ECU clearing system.

#### Structure:-

- Council composed of the Governors of the national central banks and the members of the Board. The Council would meet [every two weeks] and be chaired by [the Chairman of the Board]. A member of the Commission would attend. Decisions would be made by [qualified] majority.
- Board composed of initially 3 members (the number could increase over time) appointed for [8] years by the [European Council]. It would be responsible for day to day management and be supported by its own staff.

## Stage Two

comes into force with the ratification of the Treaty. In stage two, the final word on the conduct of policy remains with the member states. There is however a transfer of some instruments of policy to the Centre but not of sufficient magnitude to affect national policy decisions.

### Economic field

Center for economic policy co-ordination (CEPC)

#### Tasks:-

- the progressive introduction of rules relating to the size and financing of budget deficits;
- adoption of medium-term guidelines for key financial targets and economic programmes in the Member States;
- joint adoption of policy measures, when felt appropriate, as part of a co-ordinated budgetary and economic policy;
- economic management of common policies and enlarged structural funds and strengthening Community investment programmes especially in the fields of research and infrastructure;
- to take a view on the exchange rate vis-à-vis major third currencies and other international monetary matters.

Its structure would be based on that of the existing Community institutions.

### Monetary field

European System of Central Banks (ESCB), consisting of the Council, the Board and the staff and the national central banks. The ESCB would absorb the ERF.

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### Stage Three

The beginning of this stage would be marked by the irrevocable fixing of parities. This will require a shift in the ultimate responsibility for monetary policy decision-making from the periphery to the centre. There will have to be a [corresponding] shift in responsibilities for economic policy-making.

#### Economic field

A European Fiscal Framework (EFF) would be created.

In implementing the EFF the tasks of the CEPC would be as follows:-

- to impose constraints on national budgets to the extent to which this is necessary to prevent imbalances that may threaten monetary stability;
- to make discretionary changes (through a procedure to be defined) in Community resources to supplement structural transfers to member states or to influence the overall policy stance in the Community;
- to propose discretionary changes (through a procedure to be defined) in the level of harmonised taxation rates;
- to apply some form of conditionality to existing Community budgetary transfers and to Community loans (as a substitute for the present medium-term loans facility);
- to decide the exchange rate policy vis-à-vis major third currencies.

#### Monetary field

The tasks of the ESCB would be expanded to include:-

- full responsibility for the formulation of monetary policy in the Community would be attributed to the ESCB Council, replacing the [binding] ex ante co-ordination procedure followed during the preceding stage;
- decisions on exchange market interventions in third currencies would be made entirely under the responsibility of the ESCB Council; the execution of interventions would be entrusted to (one or?) national central bank;
- the implementation of the Community's monetary policy would be carried out by the Board in co-operation with national central banks. In order to be able to influence overall monetary developments in accordance with the decision of the ESCB Council, the Board would be empowered both to impose and vary minimum reserves [in ECU, national currencies, third currencies?] to be held by national central banks and to operate directly in the money markets.

Its structure would be adapted to increase the number of Board members and enlarge its permanent staff.

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COVERING

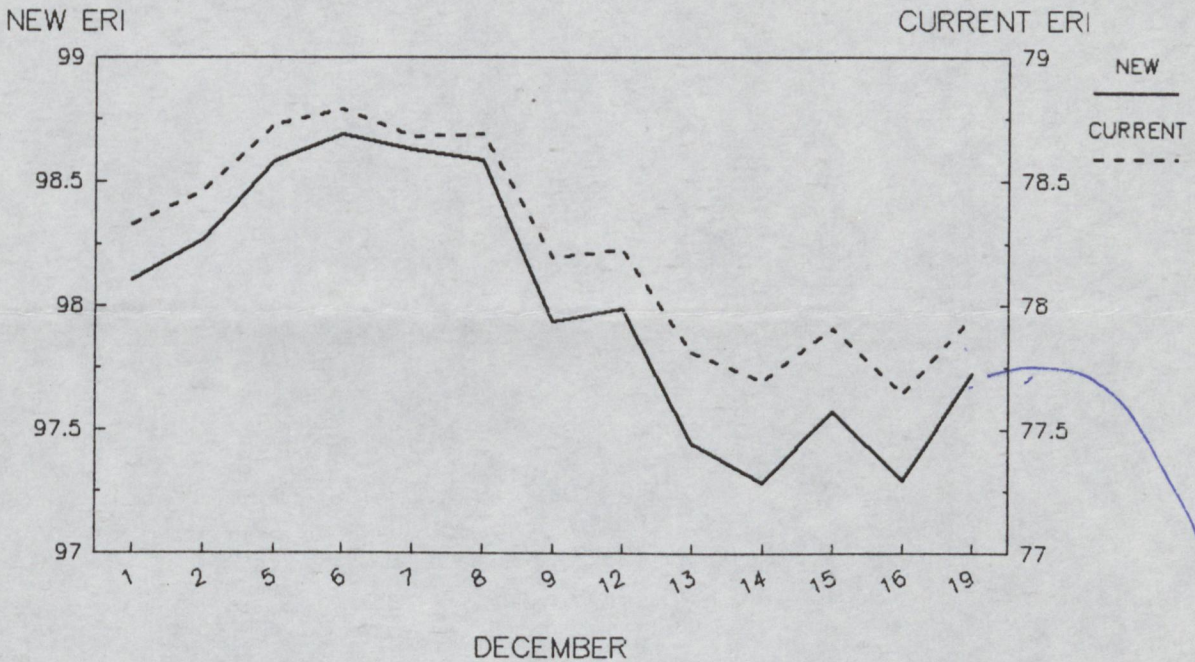
SECRET

Prime Minister<sup>2</sup>.

MG EVENING REPT.

7a

STERLING ERI: CURRENT AND NEW INDICES



The purpose of this note is to draw attention to the introduction of a new official ERI for sterling which the Bank of England will publish from 3 January 1989.

The change was announced in the November edition of the BEQB and the December edition of the EPR.

Since the change in index has attracted little press attention, IDT have agreed to take appropriate opportunities to remind commentators of the change in the ERI.

Today's closing ERI was 78.0; the new index would have been 97.7.

77.7

NPW

N P WILLIAMS

FOREIGN EXCHANGE MARKETS

MG EVENING REPORT

Monday 19 December 1988

Exchange \$/currency

Previous close		Today opening 8.30am	Today close 4.00pm	since Plaza	since Paris	since 16 October 1987
77.7	£ERI	78.0	78	-4.9	12.9	6.0
1.8120	\$/£	1.8265	1.82	33.1	19.1	9.3
3.1949	DM/£	3.2037	3.2105	-17.8	15.0	7.1
1.5385	ECU/£	1.5413	1.544			
94.1	\$ERI	-	93.9	-32.7	-9.7	-6.3
1.7632	DM/\$	1.7540	1.764	61.9	3.5	2.1
124.45	Yen/\$	123.95	124.1	94.1	23.7	15.1

Jan \$15.15 Feb \$14.82 Mar \$14.60 Spot Brent Jan \$15.10 Feb \$14.77 Mar \$14.57

UK RESERVE TRANSACTIONS (\$million)

(a)	Today	This month so far	Total since 1 Apr 88	(b)	Estimated end-month position
	6	220	5327	Market intervention	399
	40	350	-1581	Off-market transactions	340
	46	570	3746	<b>TOTAL</b>	<b>739</b>
				Net borrowing	190
				Valuation changes	0
				<b>TOTAL CHANGE IN RESERVES</b>	<b>929</b>

(a) Spot and forward transactions on a done date basis.

(b) Spot transactions only on a value date basis, as in published figures.

\* On conventional assumption of no further market intervention.

OTHER COUNTRIES MARKET INTERVENTION (\$million equivalent)

Belgium -	Germany -	Italy -
Denmark -	Holland -	Japan -
France -	Ireland -	US -

MARKET COMMENT

The dollar closed in New York on Friday night slightly lower as markets adjusted their books prior to the weekend and it continued to ease in the Far East on profit taking. Today the dollar has firmed as (mainly US) corporates squared their end-year books. The dollar reached a high of DM1.7657. The markets had a Christmas feel about them and trading was generally thin. Sterling rose against the Mark today on the back of a firmer dollar and a generally weaker Mark. The Chancellor's comments during the weekend helped to give a firmer tone.

Rates at 6.25PM: \$1.8210 DM3.2113 DM/\$1.7635 Y/\$124.05

*Ian Polin*

HONG KONG	Previous	Today	Change
Hong Kong dollar	7.8085	7.8065	0.002
Hang Seng Index	2629.16	2611.84	-17.32
3 month interbank rate	9 11/16%	9 5/8%	DOWN 1/16%

Terry Smeeton

NAME: I.C. Polin  
TEL NO: 270-5556

**MONEY MARKETS**

Monday 19th December 1988

**INTEREST RATES**

	£ Interbank		Eurodollar	
	Today	Change	Today	Change
7 days	12 3/8	-1/8	8 13/16	1/16
1 mth	12 13/16	-1/16	9 3/4	0
3 mth	13	-3/32	9 1/2	-1/16
12 mth	12 3/4	-1/8	9 5/8	-1/16

**BILLS**

	Today	Change
3 Month Treasury Bills	12 19/32	-1/32

**BANK MONEY MARKET OPERATIONS**

	Purchases £ m	Rates	Discount Rate on Eligible Bank Bills
Band 1 (0-14 days)			12 9/16-7/16
Band 2 (15-31 days)			12 37/64-35/64
Band 3 (32-63 days)			12 43/64-21/32
Band 4 (64-91 days)			12 39/64-37/64
TOTAL BILLS	0		
Repurchase	125	Due 21 December at 12 3/8-13/16%	
Lending			
TOTAL OPERATIONS	125	against surplus	£ 250 m

**US RATES**

	3 month CDs		10 yr Tsy Bond		20 yr Tsy Bond	
Today/Change	9.38	0.00	9.17	0.00	9.13	0.00

**STOCK MARKET**

	FT Ind-Ord		FTSE		Gilt index	
Today/Change	1434.6	-1.4	1770.5	-3.2	87.20	0.11

**MARKET COMMENT**

GILTS/INDEX-LINKED opened firmer with shorts up 1/8, mediums and longs 3/16. Early progress was lost during the day and at the close there was gains of 3/16 through the list including index-linked.

EQUITIES opened firmer, the UK provisional GDP statistics showing growth of 1.2% in Q3 and annual growth of 3.4% produced no reaction. Prices eased and the market closed little changed on the day.

Carl DAVEY

GILT-EDGED MARKET

Monday 19th December 1988

Transactions basis, cash values (£m); sales + purchases -

ISSUE DEPARTMENT: MARKET TRANSACTIONS

	Today	December
Gross sales shorts	36.9	479.1
Gross sales mediums	9.9	218.4
Gross sales longs and undated	11.1	420.7
Gross sales index-linked	8.0	157.8
Part paid calls		
Buying in non-next maturities shorts	-37.7	-427.7
Buying in non-next maturities mediums	-11.6	-399.3
Buying in non-next maturities longs	-10.6	-464.7
Buying in non-next maturities index-linked	-6.6	-160.5
CRND: Market transactions		-1.2
TOTAL 'GROSS' SALES	-0.6	-177.4
Buying in of next maturities		-20.9
Redemptions	-0.1	-2.2
TOTAL TRANSACTIONS WITH MARKET	-0.7	-200.5
		Future calls
Sales required to meet * target of £ m		

PRICES/YIELDS OF GILT-EDGED STOCKS

	Yesterday's close		Change from yesterday's close	
	Par	yield (per cent)	Price (£/32)	Yield (%)
Shorts	10.637		5	-0.04
Mediums	10.184		8	-0.04
Longs	9.488		10	-0.03

REPRESENTATIVE STOCKS

	Price (£/32)		Yield (per cent)	
	Today	Change	Today	Change
8% Treasury 1992	92 16	4	10.74	-0.04
8 3/4 Treasury 1997 'C'	92 1	7	10.15	-0.04
11 3/4% Treasury 2003/07	114 2	-12	9.82	-0.02
3% Treasury 1992	82 8	4	9.07	-0.04
2 1/2% Index-Linked 2016	103 6	4	3.73	0.00
2% Index-Linked 1994	95 1	1	3.77	0.00

GILT FUTURES

		Open	Close	Volume
Long Contract	March	95.19	95.19	8834
Medium Contract	0			