From: BARONESS SEROTA
Chairman of the Select Committee on the European Communities

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30 November, 1989

Dear Prime Minister,

As you prepare for the meeting of the European Council in Strasbourg on 8-9 December you may be interested to see the enclosed report on the Delors Committee Report which was recently agreed by the House of Lords European Communities Select Committee. It is due to be published at 11.15 a.m. on Tuesday, 5 December, so I would appreciate your treating it as **confidential** until then.

Yours,

Bea Serota.

SEROTA

The Rt Hon Margaret Thatcher, MP,
10 Downing Street,
LONDON, SW1.

CONFIDENTIAL

**EUROPEAN COMMUNITIES COMMITTEE**

**REPORT**

By the Select Committee appointed to consider Community proposals, whether in draft or otherwise, to obtain all necessary information about them, and to make reports on those which, in the opinion of the Committee, raise important questions of policy or principle, and on other questions to which the Committee consider that the special attention of the House should be drawn.

**Ordered to Report:**

Unnumbered: Report on economic and monetary union in the EC from the Committee for the study of Economic and Monetary Union (Delors Report).

**THE DELORS COMMITTEE REPORT**

PART 1 INTRODUCTION

The background to the Delors Committee

1. Calls for the European Community to create an economic and monetary union are not new. In 1969, the Heads of State and Government established a Committee to draw up a plan for union. But the subsequent Werner Report of 1970 was not put into practice, and it was not until the European Monetary System (EMS) was set up in 1979 that real progress was made. Its aim was to "establish a greater measure of monetary stability in the Community.....The EMS will facilitate the convergence of economic development and give fresh impetus to European Union".(1)

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(1) See European Communities Committee, 5th Report, 1983--84: European Monetary System (HL 39).

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2. The United Kingdom was a founder member of the EMS, but does not belong to its key feature, the Exchange Rate Mechanism (ERM).(1) Currencies which belong to the ERM are given a central parity against the currencies of the other Member States involved. The currencies can fluctuate either side of this figure within an agreed band.(2) Beyond these limits, the stability of the currencies must be defended by foreign exchange intervention or by tools of economic policy such as interest rates. The central parities can be adjusted from time to time by mutual consent of ERM members. Initially, realignments were fairly frequent; since 1983 they have become much less common. There has also been evidence that the interest rates and inflation rates of ERM members have converged. Because of this, some economists and politicians have seen the EMS as a "half-way house" to monetary union, whose record could provide evidence of the likely success or otherwise of full union.(3)

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(1) The ERM operates by agreement between the national central banks.

(2) 2.25 per cent for all ERM members except Italy and Spain, which operate a six per cent band.

(3) For the purposes of this Report, the definition of monetary union used in the Werner and Delors Committee Reports - that of irrevocably fixed exchange rates involving a common monetary policy - has been accepted.

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3. The European Currency Unit (ecu) has sometimes been seen as a step towards the most potent symbol of a monetary union, a common European currency.(1) The value of the ecu derives from a weighted average of the value of the different Community currencies, with each currency given an influence to reflect its relative economic importance.(2) Thus the deutschmark is given the largest weight, followed by the French franc, sterling, and so on. The ecu acts as a unit of account in inter-governmental transactions, and in the Community budget. A private market for the ecu has also developed. Bonds denominated in ecu offer a means of

spreading the risk of exchange rate changes across the currencies making up the ecu. In principle, quoting ecu prices for trade in goods and services may offer similar advantages.

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(1) In fact the Delors Committee, whilst acknowledging the value of the ecu in its own right, rejected claims that the ecu was a stepping stone to a common currency. In contrast to the ERM, the ecu was established by Council Regulation (1979) (Q 463, JS).

(2) This weighting is adjusted every five years.

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4. Such developments in the field of monetary cooperation have proceeded in parallel with efforts to create the Single European Market and to promote economic convergence. The 1985 White Paper on the Completion of the Internal Market called the 1992 programme "an indispensable base for increasing the prosperity of the Community as whole".(1) One of the aims of the Single Market programme is to link national economies more closely, as imperfections in the market caused by each state's national regulations and standards are removed, and economic interdependence grows. The result will be a need for enhanced cooperation in economic policy.

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(1) Completing the Internal Market: White Paper from the Commission (COM(85) 310 final), paragraph 21.

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5. The free movement of capital has always been one of the goals of the Community, and is a prerequisite for economic and monetary union.(1) The complete liberalisation of capital movements was agreed by the Council of Ministers in June 1988, and most Member States are to implement the Directive by 30 June 1990.(2) The Committee reported on the liberalisation on capital movements in November 1988.(3) The evidence and conclusions of that Report on the "European Financial Area"(4) formed the starting point for the enquiry which led to this Report.

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(1) Articles 3 and 67 of the EEC Treaty. The Single European Act called for the free movement of "goods, persons, services and capital" (Article 8A).

(2) The exceptions are Spain, Greece, Ireland and Portugal who are required to comply by the end of 1992, with the possibility of a further extension to the end of 1995 for Greece and Portugal.

(3) See European Communities Committee, 21st Report, 1987--88: European Financial Area (HL Paper 109). Part 2 of that Report summarises the economic arguments underlying the debate on the liberalisation.

(4) A European Financial Area requires free movement of capital in a Community with a completed internal market in financial services.

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6. Economic convergence can be defined in different ways. On one interpretation, convergence is achieved as Member States' key economic indicators grow closer. The EEC Treaty calls for coordination of economic policy to reduce level imbalances and to ensure stable prices and appropriate exchange rates.(1) As already noted, the members of the ERM have begun to realise these objectives, as exchange rates have stabilised and as growth rates, interest rates and inflation rates have converged. However, the Commission has continued to draw attention to serious balance of payments disequilibria throughout the Community.(2) Another interpretation of economic convergence is in terms of wealth, as the gap between the poorer Member States and the richer Member States narrows.(3) The Single European Act places great stress on the strengthening of "economic and social cohesion" and on reducing disparities between different Member States and different regions. It was hoped that the Structural Funds - the European Regional Development Fund, the European Social Fund, and the Guidance Section of the European Agricultural Guidance and Guarantee Fund - could provide the initial impetus for such convergence. In 1988 it was decided to increase the size of the Funds, which should have an annual budget of some 13.5 billion ecu (£9.3 billion) by 1992.(4)

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(1) Articles 104--107.

(2) See for example the Annual Economic Report 1988--89 (8887/88).

(3) See paragraph 40.

(4) See European Communities Committee, 14th Report, 1987--88: Reform of the Structural Funds (HL Paper 82).

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7. In recent years, the Community has developed policies which have sought to promote a specifically "European" economic and monetary policy. In line with this, the member governments in the Council of Ministers have repeatedly called for progress towards "economic and monetary union". They are also legally committed to this objective. The Single European Act added a new chapter to the EEC Treaty headed "Cooperation in Economic and Monetary Policy (Economic and Monetary Union)". Economic and monetary union was not defined. It required Member States to cooperate "in order to ensure the convergence of economic and monetary policies". But it recognised that any institutional changes in this field would require amendment of the Treaty. The objective of "progressive realisation of" economic and monetary union was reinforced at the Hanover European Council in June 1988, where a Committee was established with "the task of studying and proposing stages leading towards this union". This "Committee for the Study of Economic and Monetary Union" was chaired by Jacques Delors, President of the European Commission.(1) The Committee is usually referred to as the "Delors Committee".

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(1) As well as President Delors, the Committee consisted of the governors of the national central banks (Demitrius J Chalikins, Carlo Azeglio Ciampi, Maurice F Doyle, Willem F Duisenberg, Jean Godeaux, Erik Hoffmeyer, Pierre Jaans, Jacques de Larosiere, Robin Leigh-Pemberton, Karl-Otto Pohl, Mariano Rubio, Jose A V Tavares Moreira) together with Frans Andriessen, Vice-President of the Commission and three academic experts (Miguel Boyer, Alexandre Lamfalussy and Niels Thygesen). All members of the Committee were acting "in a private capacity".

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The contents of the Report

8. The Delors Committee Report concentrates on defining the means by which economic and monetary union could be achieved. It points out that economic and monetary union is not a purely technical matter; the goal was a Community with policies "geared to price stability, balanced growth, converging standards of living, high employment and external equilibrium".(1) While the Report explains that some transfer of decision-making power from the Member States to the Community would be essential, primarily in the fields of monetary policy and macroeconomic management, it stresses that this would not entail a "United States of Europe". The Community would continue to consist of "individual nations with differing economic, social cultural and political characteristics". However, amendments to the EEC Treaty or a new treaty would be required to provide the necessary powers. The Report also emphasises that any change should be implemented in line with the principle of "subsidiarity"; that is, that power should be transferred to Community institutions only where necessary.

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(1) Delors Committee Report, paragraph 16.

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9. The Delors Committee Report was clear in its own definition of monetary union. Capital movements must be fully liberalised and financial markets fully integrated. Monetary policies should be managed jointly in pursuit of common macroeconomic objectives. Currencies must be fully convertible and exchange rates must be firmly fixed. All these conditions would have to be irrevocable. Thus a common currency was not seen as an essential feature of monetary union. However, the Report argued that it might be seen as "a natural and desirable further development, for economic as well as psychological and political reasons".

10. The Delors Committee endorsed the view that monetary union necessarily requires a common monetary policy. As the European Financial Area became a reality, governments would realise that their national monetary autonomy was increasingly illusory; closer cooperation amongst central banks would become essential. By the time that monetary union was completed by the permanent fixing of exchange rates, a new Community institution would be required to formulate a common monetary policy and respond hour-by-hour to changing market conditions. The Report suggested a "European System of Central Banks" (ESCB). The central ESCB

institution would determine policy and manage the Community's exchange rate with third countries. It would have its own balance sheet. The role of national central banks would be to implement the instructions of the ESCB Council, although national central bank governors would sit on the ESCB Council together with nominees of the European Council. The ESCB would be "independent of instructions from national governments and Community authorities", but committed to support the Community's economic policy as formulated in the Council of Ministers (subject to an overriding legal requirement to pursue low inflation). The ESCB would report to the European Parliament and to the European Council. The need for day-to-day coordination between the ESCB and other Community institutions responsible for Community economic policy was also stressed. Indeed, economic and monetary union are described as forming "two integral parts of a single whole".

11. The key proposals in the Delors Committee Report related to monetary union. But the Committee's brief was to consider both monetary and economic union. In the event, the Report's definition of economic union was less precise than that of monetary union, but its objectives were equally far-reaching. As well as a completed Single Market, economic union would require an effective competition policy, common policies for structural change, and macroeconomic policy coordination. The Report recognised the danger of pursuing monetary union without going some way towards ironing out economic imbalances. With fixed exchange rates, regions and countries would escape some of the pressure from the foreign exchange markets to correct disequilibria, since the level of their currency would not be threatened. Governments might therefore be tempted to pursue irresponsible policies, running large budget deficits. The Delors Committee was not confident that the financial markets would provide an adequate discipline on governments seeking to finance budget deficits. They therefore suggested that binding limits should be placed on the budget deficits of the Member States, and on governments' access to borrowing. The "overall stance of fiscal policy in the medium term" would be defined. Closer assessment of economic conditions in the different Member States would also be made.

12. The Report discussed the fear of some Member States that the less developed regions in the Community may on balance lose out in an economic and monetary union. It therefore argued that it was necessary to promote structural adjustments which would "help poorer regions to catch up with the wealthier ones". But the Report recognised that the Structural Funds must not be used in a futile attempt to subsidise incomes in such regions, but should act as a catalyst for genuine economic development.

13. The Delors Committee put forward three stages to achieve economic and monetary union. The Committee did not propose that the Community should evaluate progress at the end of each stage; the only date suggested for the steps towards union was the beginning of Stage One on 1 July 1990. However, the Report stated that "the decision to enter upon the first stage should be a decision to embark on the entire process".(1)

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(1) Delors Committee Report, paragraph 39.

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14. Stage One of the Committee's plan would "aim at a greater convergence of economic performance through the strengthening of economic and monetary policy coordination". The starting date for Stage One was significant; by July 1990, the major economies of Europe will all have introduced freedom of capital movements. This is accepted as a key prerequisite for further progress towards economic and monetary union.(1) Impediments to the private use of the ecu would be removed. The Council of Economic and Finance Ministers (ECOFIN) would begin a surveillance of Member States' economic development and produce guidelines for national budgetary policy, while the Committee of Central Bank Governors would take a more active and public role in determining the direction of national monetary policy. Most importantly for the United Kingdom, all Community currencies would become members of the ERM. Negotiations during Stage One would also determine the future course of economic and monetary union; the required amendments to the EEC Treaty would be negotiated and, if accepted by national parliaments, ratified. Stage One itself represents a considerable undertaking. The completion of the Single Market and the European Financial Area, and the reform of the Structural Funds are all existing Community objectives. But taken together with the development of monetary cooperation, Stage One becomes a "quantum leap" in its own right, rather than purely a preparatory stage.

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(1) See paragraphs 34--6.

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15. Stage Two was intended as a transitional stage. The work to complete the Single Market and to maximise the effects of the Structural Funds would be assessed and, if necessary, reinforced. Coordination of economic policies would continue to be improved, with the Council acting as a training ground for collective decision-making. For example, the Council would set precise - although not yet binding - rules for national budget deficits. Monetary policy would gradually become centred on the Community and some reserves would be pooled and used for foreign exchange intervention. The new body responsible for monetary policy, the ESCB, would be set up, and existing institutions such as the Committee of Central Bank Governors disbanded. The ESCB's main role would be to begin the formulation and implementation of a common monetary policy. As for the ERM, realignments would only be made in extreme circumstances and the permitted margins of fluctuation would be reduced.

16. Stage Three would be the final stage in the process. The Council would have the power to make decisions which would be binding on the Member States, for example placing limits on national budget deficits. Exchange rates would be locked irrevocably, and the ESCB would take on its full role and pool all official reserves. If the Community chose to move to a single currency, it could now do so.

Recent developments

17. The Delors Committee produced its report in April 1989. It was discussed at the Madrid European Council in June 1989. The following is an extract from the Presidency Conclusions on the Council:

> 1. The European Council restated its determination progressively to achieve economic and monetary union as provided for in the Single Act and confirmed at the European Council meeting in Hanover. Economic and monetary union must be seen in the perspective of the completion of the Internal Market and in the context of economic and social cohesion.
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> 2. The European Council considered that the report by the Committee chaired by Jacques Delors, which defines a process designed to lead by stages to economic and monetary union, fulfilled the mandate given in Hanover. The European Council felt that its realisation would have to take account of the parallelism between economic and monetary aspects, respect the principle of "subsidiarity" and allow for the diversity of specific situations.

3. The European Council decided that the first stage of the realisation of economic and monetary union would begin on July 1 1990.

4. The European Council asked the competent bodies (the Ecofin and General Affairs Council, the Commission, the Committee of Central Bank Governors and the Monetary Committee):

a) to adopt the provisions necessary for the launch of the first stage on July 1 1990;

b) to carry out the preparatory work for the organisation of an inter-governmental conference to lay down the subsequent stages; that conference would meet once the first stage had begun and would be preceded by full and adequate preparation.

These conclusions were agreed by all Member States. They make it clear that Stages Two and Three of the Delors Committee proposals were not seen as a "blueprint", but were to act as a basis for inter-governmental discussion.

18. In September 1989, the Commission made its first formal proposals. First, a new version of the 1964 Decision on national central banks was proposed, setting up a Committee on Central Banks. This sought to promote cooperation amongst the central banks. The second proposal aimed to develop the 1974 Decision on economic cooperation in order to increase convergence of economic policy.(1) The Council of Ministers would conduct regular scrutiny of the economic situation and national policy in each of the Member States. These discussions would impose no direct control on Member States' economic policy, but the Commission hoped that the process of mutual surveillance would help Member States to realise when their economies were diverging from Community norms.

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(1) Council Decision amending the Council Decision of 8 May 1964 on cooperation between the Central Banks of the Member States of the EEC and Council Decision on the attainment of progressive convergence of economic performance during Stage One of economic and monetary union (OJ C 283, pages 6--9, 9 November 1989).

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19. The Committee's enquiry began in the wake of the Madrid summit. The Member States agreed at Madrid to implement Stage One, so the enquiry sought to consider the likely progress of Stage One and to examine the Delors Committee's proposals for Stages Two and Three. The discussions about economic and monetary union have developed since the Madrid summit; it should be noted that many witnesses did not have an opportunity to comment on the two proposals described in paragraph 18, or on the United Kingdom Government's "alternative" to the Delors Committee Report, published in November 1989.(1)

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(1) An Evolutionary Approach to Economic and Monetary Union (HM Treasury, November 1989). See pages 00--00.

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20. Sub-Committee A (Finance, Trade and Industry and External Relations), whose members are listed in Appendix 1, received the evidence listed in Appendix 2. The Committee are most grateful to all their witnesses. They are particularly grateful to Mr Jacques Delors, President of the European Commission, who talked informally to members of Sub-Committee A in Brussels.

## PART 2 EVIDENCE

### THE CASE FOR ECONOMIC AND MONETARY UNION

21. The Delors Committee did not set out the case for economic and monetary union. As already noted, they took this goal for granted, and explained how their interpretation of that goal might be reached (Q 28). Lord Cockfield argued that this was scarcely surprising, since the Community had already committed itself to European union by the Solemn Declaration of Stuttgart in June 1983, and by the Single European Act.(1) Monetary union and economic union were "already agreed and accepted Community policy" (QQ 99, 139--141, 455). But most witnesses took the opportunity to comment on the arguments for such developments.

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(1) For the Government's interpretation of these statements see the evidence of the then Chancellor of the Exchequer to the House of Commons Treasury and Civil Service Committee (HC 341, 1988--89, QQ 78, 81--2). His argument was that the Government had hitherto understood economic and monetary union as cooperation in economic and monetary policy. Title II, Chapter 1 of the Single European Act is headed "Cooperation in Economic and Monetary Policy (Economic and Monetary Union)". The Treasury Committee found the Chancellor's interpretation "surprising", and concluded that "ever since 1972 successive British Governments have gone along with the idea of economic and monetary union, because it seemed unlikely to be a serious issue for some time" (paragraph 10).

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22. The political case for economic and monetary union is that it would make the Community into a more powerful world player than the sum of the 12 Member States. The Delors Committee Report states that: "The establishment of an economic and monetary union would give the Community a greater say in international negotiations and enhance its capacity to influence economic relations between industrial and developing countries".(1) The Right Honourable Mr Robin Leigh-Pemberton, Governor of the Bank of England and a member of the Delors Committee, argued that "the more effective the economic and monetary union of the Community ... the better equipped it will be as a trading entity to compete with the big economies of the United States and Japan". Mr John Stevens MEP said that monetary union was one of the issues which would "make or break" the Community (QQ 34, 41, 356,

478--9, 482, ICI, JS). Mr Cornelius van der Klugt, Chairman of Philips and President of the Association for the Monetary Union of Europe,(2) said that only if the Community took advantage of such opportunities by embracing economic and monetary union could it meet the challenge of developments in Eastern Europe (QQ 353, 358, 440, JS). Sir Leon Brittan, Vice-President of the European Commission, supported this view, adding that "there is no justification whatsoever for allowing developments in Eastern Europe to delay by one single second [progress] in the European Community.....The best ally of liberalisation and the growth of freedom in Eastern Europe is a strong European Community". But the Institute of Directors warned that if the Community were to become a "Fortress Europe", it would harm long-term competitiveness (Q 422, IOD).

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(1) Paragraph 35.

(2) The Association is an organisation of over 200 of the largest private sector enterprises in Europe. It runs meetings and issues publications to support its goals which include a single currency and a European Central Bank (QQ 324, 327--8).

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23. Witnesses gave four arguments to describe the economic advantages of monetary union.(1) The most important argument was that the advantages which Europe would gain from the Single Market programme would be multiplied if accompanied by monetary union. Many witnesses saw monetary union as a logical, if not an essential, extension of the Single Market programme, allowing a "deregulation of the mind" that would encourage greater use of cross-border opportunities. Such benefits would only come with a single currency; the degree of stability provided by the European Monetary System would not be sufficient (QQ 40, 278, 343, 403, 477, 479, 488, JS). Mr van der Klugt said that Europe was currently at a serious competitive disadvantage vis-a-vis Japan, with the fragmentation of the Community market "hanging a handicap around our necks" (QQ 333--4). In a pure and complete Single Market, he estimated that prices could fall by six to eight per cent.

why?

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(1) See European Communities Committee, 21st Report, 1987-88: European Financial Area (HL Paper 109), paragraph 61.

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24. Second, both business and personal travellers had to pay transaction costs when changing from one currency to another. It is said that a traveller visiting all 12 Member States of the Community and changing money in each would lose 40 per cent of the value of his money in transaction charges alone (FC). Rates are less exorbitant for business, but firms also face the administrative costs of accounting for the changes, plus the time involved. An exact estimate of the cost of these transactions is difficult (QQ 39, 294--5, 403, 487). But some economists have put it as high as two per cent of GDP.(1) Mr John Stevens MEP estimated that in some firms, foreign exchange exposure could account for 10 per cent of management resources (JS).

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(1) See for example Professor Michael Artis in S. Brittan and M. Artis, Europe Without Currency Barriers (Social Market Foundation, 1989).

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25. Some witnesses argued that a single currency was not essential to remove transaction costs (FC). If different currencies with fixed exchange rates were allowed to circulate across the Community, they could be freely interchangeable at no cost, like the English and Scottish pound. But Mr Joly Dixon of President Delors' Cabinet, European Commission, pointed out that the English/Scottish example was unusual in being a one-for-one exchange (Q 308).

26. Third, all witnesses seemed to agree that the costs of currency fluctuations were even higher than those of transaction costs. Businesses had to insure themselves against the threat of fluctuations.(1) This could be costly, and sophisticated hedging techniques were often not at the disposal of small businesses (QQ 171, 180, 337). But the alternative to such insurance could be worse. Mr John Banham, Director-General of the Confederation of British Industry, pointed out that "hard-won improvements in productivity and cost control have been wiped out overnight in many industries by quite abrupt fluctuations in the currency". The "vast bulk" of CBI members therefore

supported a move towards monetary union (QQ 180, 182). Sir Fred Catherwood MEP noted that during the 1980s, the sterling rate against the deutschmark (DM) had varied between 5.07 DM and 2.74 DM. Exchange rate fluctuations and high interest rates were preventing the recovery of manufacturing industry in the United Kingdom (FC). Mr van der Klugt said that such changes could "wreak havoc with the best-run company" (QQ 332, 347). He stressed that his belief in monetary union was based not on a doctrinaire enthusiasm for European union, but was a hard-headed commercial decision already suggested by the use of the ecu by American and Japanese companies. He placed the total advantages of union for his company at one per cent of turnover - "tens of millions of pounds" (Q 336).(2) Mr Gavyn Davies, Chief UK Economist for Goldman Sachs, noted that the case for these benefits had "never really been proven", though a study by the European Commission is now in hand (QQ 39, 294--98). The most sceptical evidence about these benefits came from the Institute of Directors, who said that business' gains "would not necessarily benefit the economy as a whole or in its regions" (IOD).

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(1) Mr Sam Brittan in Brittan and Artis op. cit. argued that "the problem is not short fluctuations, but major swings and misalignments going far beyond the inflation differentials and other factors to which businessmen in principle could adjust". A free trade area without the monetary component "would not justify the term Single Market".

(2) Mr Walter Eltis, Obstacles to European Monetary Union (National Economic Development Office, 1989), gave the overall benefits of union as one to one and a half per cent of the combined national incomes of the Community.

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27. The final argument for the economic benefits of monetary union and a common currency was that it would bring macroeconomic advantages. Sir Fred Catherwood argued that Europe needed a currency to rival the dollar and the yen. At present, the heavy trading in the dollar meant that it was traded at a lower cost than European currencies. The power of the dollar also forced Europe to respond to decisions made in the United States purely on the grounds of domestic policy - such as rises in United States interest rates - and lessen European vulnerability to changes in commodity prices. A common European currency would be strong enough to avoid the United States' lead, and might indeed have a greater

influence on such decisions across the world. It would also be cheaper to deal in the European currency, encouraging savings to stay in Europe (Q 34, FC, JS).(1) Both Sir Fred Catherwood and Mr Leigh-Pemberton pointed to another possible advantage; in a monetary union, governments might be freer to pursue policies aimed at addressing the real deficiencies in their economies, since it would no longer be possible to measure trade imbalances (QQ 21--2, 373, FC, JS). But the main arguments for macroeconomic gains have been based around the perceived success or otherwise of the European Monetary System.

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(1) See Professor Richard Portes, Macroeconomic Policy Coordination and the European Monetary System (CEPR, September 1989).

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THE EUROPEAN MONETARY SYSTEM AND STAGE ONE

28. The Exchange Rate Mechanism of the EMS is generally described as a success on two counts. First, it has succeeded in giving its members a large (and, to many economists, unexpected) degree of exchange rate stability. Realignments have been necessary, but they have become rare and have increasingly foiled speculators seeking a one-way bet by allowing currencies to move smoothly from, say, the bottom of the old band to the top of the new band. Mr Banham believed that the United Kingdom's failure to join had proved "very damaging to [business'] ability to build, profitably, long-term strategic positions in some of the key markets of Europe" (QQ 154, 178, 214, FC). Second, ERM members have increasingly benefited from low inflation, with inflationary expectations being dampened down. This has even been true of members with a tradition of high inflation (QQ 39, 55, 183, 338, 343, 377, 421, FC). ERM members have also enjoyed relatively low levels of interest rates. Mr Leigh-Pemberton estimated that the effort required to manage a currency outside the ERM forced an extra one to two per cent on interest rates (QQ 10, 374--5, 377, 392, 449, JS). Finally, membership of the ERM has been seen as lending credibility to the governments involved.(1) Mr Davies saw the credibility of monetary policy provided by the ERM as helping the maintenance of low inflation at low cost, though Mr Graham Bishop of Salomon Brothers International feared that the Government's history of having a "lack of enthusiasm" for the ERM would deprive the United Kingdom of the full benefits of membership in terms of added credibility (QQ 56, 377--9, 390).

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(1) Eltis (*op. cit.*) cast doubt on this credibility, pointing out that from the starting date of March 1979 (the establishment of the EMS), the lire had fallen 40 per cent against the deutschmark and the French franc 33 per cent, both considerably higher than sterling's 17 per cent.

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29. The reason for these successes is generally seen as the domination of the EMS by the deutschmark. The German central bank, the Bundesbank, is independent of government and has a legal responsibility to maintain low inflation. The other members of the ERM have therefore been tied to the discipline imposed by the Bundesbank, and have accepted the need to avoid inflationary overspending (QQ 33, 117, 338, pp 31--2, PM).(1)

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(1) See paragraph 57.

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30. It has been argued that the low inflation characteristic of the system has been achieved at the expense of growth and employment. Professor Patrick Minford of Liverpool University argued that the United Kingdom should not join the mechanism because - unlike countries such as France and Italy - it had shown itself capable of maintaining a credible anti-inflation policy without externally imposed discipline. Joining would merely expose the United Kingdom to the unpleasant side-effects of the system, with none of the benefits. Indeed, Professor Minford was sceptical about whether the system had succeeded in "its principal appointed task of lowering overall (as opposed to intra-EMS) exchange rate uncertainty",(1) and pointed out that ERM members did not have a monopoly on falls in inflation (PM, IOD).

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(1) In contrast, Professor Michael Artis and Professor Mark Taylor argued that "there is strong evidence of reduced intra-ERM exchange rate volatility post-March 1979, and signs of increased volatility in dollar and (to a slightly lesser extent) sterling rates" (The Achievement of the European Monetary System, Economic and Social Review, January 1989). They also argue that the ERM has brought relatively stable interest rates.

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31. For many years, the Government have stated that they would join the mechanism "when the time is right". At the Madrid summit in June 1989, the Government clarified its conditions for entry as requiring United Kingdom inflation to be brought down to the Community average, the successful liberalisation of capital movements, and "real" progress towards the Single Market.(1) Mr Peter Lilley MP, Financial Secretary to the Treasury, explained that the Government did both "want and expect" to join the mechanism, but had to be sure that the system would work before entering. The United Kingdom's conditions were such that it was impossible to put a timetable on entry. The Government, supported by Mr Leigh-Pemberton and Professor Charles Goodhart of the London School of Economics, were concerned that the operation of the whole mechanism could be jeopardised if the United Kingdom joined whilst inflation remained high. The entry of sterling might force the EMS to realign more frequently (QQ 10, 155, 218, 240, 252). But the majority of witnesses encouraged the Government to join the ERM. Mr Banham argued that United Kingdom membership was "long overdue" and that further postponement made it harder for business to plan for the Single Market and the opening of the Channel Tunnel (QQ 180, 182, UNICE). Both Mr Banham and Sir Leon Brittan were confident that inflation was already coming down (QQ 180, 444).

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(1) See the Prime Minister's statement on the Madrid European Council (HC Deb 29 June 1989, cols 1107--1110). See also An Evolutionary Approach to Economic and Monetary Union (HM Treasury, November 1989).

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32. Those pressing the Government to join the mechanism argued that unless the United Kingdom joined soon, it would be difficult to influence any negotiations about economic and monetary union, or indeed about the Single Market programme. Membership was an important symbol of commitment to the

Community, and existing members of the ERM were already annoyed that the stability of the ecu was being undermined by sterling. Mr van der Klugt estimated that fluctuations in the pound destabilised the ecu by some three to five per cent (QQ 18, 211, 339, 341, 405--6, 463, FC). Mr Banham reported that the perception that the United Kingdom were obstructing progress had made the British into "pariahs" in certain European circles, and Mr Leigh-Pemberton sensed that the United Kingdom was seen "as not a fully committed member of the club" (QQ 27, 180). But Mr Lilley argued that the United Kingdom's record in making progress towards the other elements of Stage One, such as the Single Market, the European Financial Area and the use of the ecu was such that it was for others to "catch up" (QQ 63, 205, 221--2, 230, 272, 426, CW). "Informal" restrictions on the free movement of capital, which existed in many Member States, still had to be addressed by Commission proposals (QQ 223--4, 424). The Institute of Directors said that if these difficult questions "were put to some of those Member States apparently so keen on economic and monetary union, it would be interesting to see the speed at which their enthusiasm might evaporate" (IOD). But Sir Leon Brittan did not believe that the Government should insist on further progress in the Single Market programme as a precondition for ERM entry; such progress was of course desirable, and was indeed being made all the time, but if every Member State demanded the completion of one objective before moving on to another, the result would be stalemate. In some aspects of the Single Market programme, it was the United Kingdom that was "behind" (QQ 421, 425, 429, 442, 447, 455).

33. Another argument used in favour of membership was that the Government failed to take into account the unusual composition of the retail price index in the United Kingdom. Mr Banham argued that price rises in the shops were very much in line with the United Kingdom's major competitors (Q 182). He said that United Kingdom membership could only reinforce its commitment to low inflation (Q 180). Lord Cockfield also suggested that membership of the ERM would itself act as a welcome discipline, pulling United Kingdom inflation further down (QQ 10, 55, 182, 343). Sir Fred Catherwood likened the Government's insistence on bringing inflation down first to "promising to take aspirins as soon as our temperature has come down to normal. Community experience is that it is only the fixing of the national currency to the EMS which can reduce inflationary expectations." Mr Dixon argued that the United Kingdom's main economic indicators were out of line precisely because the country remained outside the mechanism (Q 314, FC).

34. However, some witnesses suggested that such arguments about the current state of the ERM were academic, in that the mechanism was entering a period of change. They argued that at present, the ERM succeeds because it is protected from damaging speculation by exchange controls. These are to be dismantled by most Member States by July 1990. The fear was that the system will not be able to hold exchange rates within the current bands of fluctuation when left unprotected from speculation (QQ 153--7, p 33, FC, ICI). Even advocates of a more gradual approach, such as Mr Leigh-Pemberton, recognised the vulnerability of linked exchange rates short of a common currency, though Mr Dixon pointed out that Stage Two of the Delors Committee plan left scope for realignments (QQ 25--6, 311). Sir Fred Catherwood also argued that the system will come under pressure in the early years of the completed Single Market as trade balances are upset by differences in the ability of Member States to take advantage of the new conditions. It would also need to accommodate the currencies joining during Stage One. In contrast, Lord Cockfield was confident that sterling could be assimilated smoothly (QQ 60, 120, FC, ICI).(1)

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(1) Professor Michael Artis in Brittan and Artis op. cit. argued that sterling should join the ERM on a wide band.

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35. But many witnesses supported Sir Leon Brittan's belief that "anxiety about what happens next July need [not] cause a delay" in United Kingdom membership of the ERM (QQ 7--8, 173, 373, 397--400, 421, 430--1, 477, JS). The fact that France has already dismantled many of its controls, with no harmful effects, reassured most that the system could survive full liberalisation fairly comfortably. Sir Leon Brittan gave evidence that the financial markets in France were not expecting any great turbulence. Mr Bishop said that the "key" exchange controls in Italy had already gone. But others were more concerned about Italy, due to the reliance of successive governments on a high level of private savings to finance government deficits, and due to the intention to reduce the scale of fluctuation allowed to the lire. Mr Leigh-Pemberton thought that in any event, by July 1990 one should have "a pretty clear idea" of how the liberalised system would work (Q 6).

36. Such arguments over the stresses which the EMS may face in the coming years have a direct bearing on the timetable for any progress towards monetary union. Thus far, the only

date set is for the commencement of Stage One on 1 July 1990. Lord Cockfield called for a timetable for further steps, and Mr van der Klugt expected that the Community would be ready to move on from Stage One by 1992 (QQ 120, 137, 348). If the EMS does come under pressure, it could respond either by widening the bands of fluctuation and accepting a "watered down" EMS, or by tightening the system, with narrower bands and increased mutual intervention to ensure credibility - in effect, the fate of the ERM in Stage 2 of the Delors Committee Report. In fact, the political climate in the Community is such that the option of a looser EMS is not being seriously discussed(1). Sir Fred Catherwood believed that "our partners do not think that they can afford to wait to see whether free movement of currency is possible without disaster", though Mr Banham believed that the ERM could be tightened without going as far as monetary union (QQ 130, 180, FC).(2) Professor Goodhart, supported by ICI, argued that the right course for the Community was to jump immediately to fixed exchange rates (Q 155, p 34, ICI).

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(1) See European Communities Committee, 21st Report, 1987--88: European Financial Area (HL paper 109), paras 85--88.

(2) Similarly, Mr Dixon predicted that the process of achieving unity might be difficult, and that Member States might wish to get the pain "over and done with" (Q 313).

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37. Witnesses who were confident about the future of the ERM anticipated a far longer timetable. The Union of Industrial and Employers' Confederations of Europe (UNICE) argued that "the implementation of each successive stage should be conditional upon the complete achievement of all the conditions characterising the previous stage". The Community should wait until it was "satisfied" that the Single Market was operating efficiently. Indeed, Mr Bishop argued that consumers in a genuinely liberalised Single Market in financial services would themselves push the Community towards monetary union (QQ 364, 411-3, 460, 491, UNICE). Sir Leon Brittan thought that those working in central banks would probably favour a fairly long timescale, though as Stage One developed people would begin to favour further progress. There was certainly no need to rush into an inter-governmental conference without full preparation. Mr Leigh-Pemberton also believed that it might take a few years to prepare the people of Europe for economic and

monetary union, and that a sudden jump might create administrative chaos and be detrimental to the real economy. He therefore saw preparations for a possible move to Stage Two beginning in the middle years of the 1990s (QQ 15--16, 24, 29, 432, 436--8, 455, IOD).

38. But Mr Davies argued that even the mid-1990s would be far too early; Stage One was a considerable endeavour in itself, and it would take "many, many years" - one or two decades - to give economic agents the chance to respond to the Single Market (QQ 59--60). Similarly, Mr Banham thought it "unreasonable" to expect steps beyond Stage One to be taken in the near future. He pointed out that the process of integrating sterling into the EMS could take some years (Q 180). Mr Lilley explained that the Government's approach was to "make clear what is feasible and practicable and then work out ideas that will stimulate other people's ideas and get to useful, practical consequences as a result". The Government saw no need to impose timetables on the process (QQ 170, 227, 240, 251). There had been no agreement to move beyond Stage One, and the leap from the EMS to monetary union could not be undertaken lightly (Q 238). The Government have stressed that Stage One itself is "an unprecedented endeavour whose significance cannot be overstated".(1) Sir Leon Brittan pointed to a possible compromise, noting that it would be "perfectly possible" to reach a fairly precise agreement on the form of economic and monetary union "but to put dates on implementation rather later on". This might also act as a "contingency plan" in the event of pressures seriously threatening the system (QQ 434, 460--1).(2)

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(1) An Evolutionary Approach to Economic and Monetary Union (HM Treasury, November 1989), paragraph 7. See paragraphs 42 below.

(2) Such a compromise finds echoes in the Opinion of the Section for Economic, Financial and Monetary Questions of the Economic and Social Committee.

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39. Mr Lilley wished to pursue the opportunities for enhanced cooperation which already exist under the framework of the EEC Treaty, such as the increased use of the ecu (Q 249, p 54, UNICE). The changes proposed to the Committee of Central Bank Governors and the Council of Economic and Finance Ministers(1) were widely welcomed, although Mr Davies believed that the governors needed more independence from their governments (QQ 85--6). Mr Leigh-Pemberton explained

that the current Committee of Governors was "very informal", and that its decisions were "very much *ex-post* the event". The plan was for the Committee of Governors to make more resolute and public judgements on policy, sometimes commenting in advance of decisions. It would not be able to impose policy, but its voice would undoubtedly be influential, particularly if its chairman were to sit in the Council of Ministers during the planned discussions on national and Community economic policy (QQ 2--3, 115, 287--291). The Institute of Directors said that the calls for budgetary coordination in Stage One were futile. If the phrase meant real coordination, it would take decades to achieve; if not, it was a token gesture, "contentless at best and dangerous at worst" (IOD).

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(1) See paragraph 18.

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40. Another element in any decision about the timing of Stage One is the degree of economic convergence achieved in the Community. Mr Leigh-Pemberton considered that in recent years, the Community had made "very considerable" progress towards convergence of economic performance.(1) However, further advances were essential before moving on from Stage One, particularly in the convergence of Member States' inflation rates, interest rates, government deficits and trade balances. He had argued in the Delors Committee that an economic and monetary union would be "much more healthily based" if the Community did not "push forward.....formal movements to monetary union until there is in parallel adequate convergence in the real economic situation" (QQ 1, 15--16, 19--22). Hence the stress in the Report on "parallelism", endorsed in the conclusions of the Madrid summit.(2) Mr Davies thought that "unless we see a prolonged period of genuine economic union as a prelude to full monetary union...we will be taking too big a risk". Completely free trade in goods and services, irrevocably free capital movements and far more mobility of labour needed to be in place (QQ 42--3, 67, 421, BBA). The Institute of Directors argued that economic union was more likely to create a demand for monetary union than a premature monetary union was likely to produce economic union (IOD).

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(1) In contrast, recent examinations of the economic situation in the Community by the Commission have stated that Member States' performances are clearly diverging. This criticism was largely directed at the United Kingdom, Portugal and Greece (see for example document 7782/89, COM(89) 333 final, Second Quarterly Examination of the Economic Situation in the Community for 1989).

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41. But Lord Cockfield, supported by Sir Leon Brittan and Mr van der Klugt, did not believe that economic convergence should be made a precondition of union. The two developed in parallel, each sustaining the other. Thus the EMS and the liberalisation of capital movements both increased convergence, and a degree of convergence was required to prevent countries' economies in a monetary union falling seriously out of step with their partners (QQ 98--100, 131, 172, 409, 435, UNICE, VDK, JS). This was true of convergence both in the sense of a levelling-out of differences in economic conditions and in the sense of similar inflation rates and interest rates. ICI argued that trying to maintain fixed but adjustable exchange rates in an unstable climate could in fact delay convergence (ICI). Mr Dixon pointed out that it was difficult to predict which areas might use their "natural" advantages best in the future; the aim of the Single Market and monetary union was to give each region the chance to make the most of its potential (QQ 20, 322).

## THE CASE AGAINST ECONOMIC AND MONETARY UNION

### Loss of sovereignty

42. Mr Lilley made it clear that the Government's major objections to the Delors Committee proposals for Stages Two and Three - the achievement of economic and monetary union - were on the grounds of national sovereignty and loss of democratic accountability. Mr Lilley said that the Report had made it plain the "very substantial" transfers of sovereignty would be required, giving powers to "some central and unelected and undemocratic bodies". That was "simply not on the agenda", and would lead to a "federal super-state in Europe" (QQ 232, 266, pp 38, 55).(1) This interpretation of the proposals for Stage Three was supported by the Institute of Directors. They considered that "all powers to determine the size of national public sectors" would be lost, and that

the loss of control over taxation would produce "a democratic deficit of monumental proportions".(2) This deficit could only be put right by the creation of "a European Government directly elected by the people, responsible to an elected and representative Parliament" (IOD). In contrast to the gold standard system, once a currency had joined the system, it would be difficult indeed to leave, and Professor Minford feared that a European Central Bank's commitment to pursue inflation could never be totally reliable. The United Kingdom could therefore be trapped inside an unsatisfactory system (Q 32, PM).(3)

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(1) The Chancellor of the Exchequer has laid particular stress on the need for parliamentary accountability: "The proposals in the Report make no provision for accountability for monetary policy to national governments or national parliaments. Yet the electorate would still hold governments ... responsible for their economic well-being, and rightly so ... The Government's fundamental objection to Delors approach beyond Stage One is that its prescription for economic and monetary union centralises power. It relies on administrative fiat and institutional change. It skates over vital issues of political accountability" [HC Deb, 2 November 1989, cols 488--495].

(2) See House of Commons Treasury and Civil Service Committee, 4th Report, 1988--89: The Delors Report (HC 341), paragraph 27.

(3) Mr Sam Brittan in Brittan and Artis op. cit. pointed out that it is not impossible to leave a monetary union, citing Ireland leaving the sterling link in 1979 as the most recent example.

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43. The United Kingdom Government have outlined their proposed alternative to the Delors Committee proposals.(1) They argue that as Stage One progresses, Member States will face pressures forcing them to pursue lower inflation and more stable exchange rates. The costs and inconvenience of maintaining a multi-currency system will reduce. The substitution of currencies will increase, with greater use being made of predictable "low inflation" currencies in transactions and deposits(2). Supported by further progress on the creation of a genuinely liberalised European Financial Area, the development of these pressures over many years would lead to the evolutionary achievement of the

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the loss of control over taxation would produce "a democratic deficit of monumental proportions".(2) This deficit could only be put right by the creation of "a European Government directly elected by the people, responsible to an elected and representative Parliament" (IOD). In contrast to the gold standard system, once a currency had joined the system, it would be difficult indeed to leave, and Professor Minford feared that a European Central Bank's commitment to pursue inflation could never be totally reliable. The United Kingdom could therefore be trapped inside an unsatisfactory system (Q 32, PM).(3)

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Government's vision of monetary union, a system which "could evolve" into one of fixed exchange rates. Indeed, competition between Member States' central banks to uphold the credibility of their currencies would be a far more reliable anti-inflationary strategy than a commitment to low inflation in the constitution of an independent European Central Bank. The great advantage of the scheme was that it avoided the constitutional implications of the Delors Committee proposals. Professor Minford agreed that such a system would force governments to deliver low inflation and minimum transaction costs, with currency union emerging naturally once inflation was low and equal (PM, IOD).(3) But Mr Dixon and Mr Leigh-Pemberton pointed out that, whatever the merits of the plan, the retention of (albeit limited) floating exchange rates in such a system could not be squared with the definition of monetary union used in the Werner Report and the Delors Report (QQ 31, 302--4, 463).(4) Mr Stevens added his fear that a regime of competing currencies might in fact be inflationary (JC). The system would only work if the real objective was the increasing acceptance of one Member State's currency, presumably the deutschmark, as the common unit; a solution unlikely to be welcomed by either the Bundesbank or the other Member States. Mr van der Klugt welcomed the Treasury's proposals if genuinely seeking a common currency, but feared that it would not be "very efficient" to leave the process to market forces. This might take too long and some political decisions would be unavoidable (VDK).

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(1) An Evolutionary Approach to Economic and Monetary Union (HM Treasury, November 1989).

(2) Mr Sam Brittan in Brittan and Artis op. cit. called competing currencies "a recipe for a free trade area rather than a monetary union. Given the tenacity with which people hang on to familiar national currencies, even in the absence of compulsion, it would take a very long time before one currency prevailed; and in the meantime unpredictable exchange rate fluctuations would remain".

(3) Professor Richard Portes has pointed to the dangers of currency substitution, with the threat that the demands for currencies "could shift rapidly and unpredictably" (Paper delivered to CBI Conference, October 1989).

(4) The objectives of monetary union given in the Treasury's paper are price and currency stability; lower costs of financial transactions, especially across borders; and equal access to financial instruments and services by all citizens and other borrowers and lenders within the Community. This conflicts with the definition given in the Werner and Delors Committee Reports, which requires irrevocably fixed exchange rates or a single currency. It also seems to conflict with the evidence of the then Chancellor of the Exchequer to the House of Commons Treasury and Civil Service Committee in June 1989: "it is very clear what is meant by monetary union. Monetary union is a single currency - a common currency - which obviously requires a single monetary policy and a single central bank" (HC 341, 1988--89, QQ 80--2).

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44. Some European politicians are sympathetic to the development of a federal Europe.(1) Indeed, Lord Cockfield argued that the Community had already committed itself to "European union" by the Solemn Declaration of Stuttgart in 1983 (Q 99). But others took issue with the United Kingdom's Government view on the grounds that they placed too great a weight on the concept of sovereignty. Mr van der Klugt said: "I think the prosperity of the working people takes precedence over imaginary questions of sovereignty" (Q 339). Some also took the view that the Government's interpretation of the Delors Committee proposals suggested that far more powers would be concentrated in the centre than was actually the case. Finally, several supporters of some form of monetary union have suggested "alternatives" to the Committee's Stage Three, generally proposing "minimalist" solutions. Mr. Stevens said that it was possible to have an "economically workable" system with far less centralisation than the Delors Committee proposals imply, which would not "be perceived to derogate significantly from national sovereignty". It was difficult to believe how governments committed to "free market, small government, sound money economic policies" could really regard such a system as a "fundamental threat to national sovereignty". European monetary union should be seen as a purely "technical" matter, and there was a "growing consensus" in favour of such a monetary union (JS, QQ 483, 490, 492). Professor Goodhart also argued that a move to irrevocably fixed exchange rates, a single currency and an ESCB could be achieved "with a minimum of federal oversight, fiscal transfers, international official coordination or conscious steps to achieve convergence" (Q 29, pp 31, 37).

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(1) See for example President Mitterrand's speech to the European Parliament, 25 October 1989.

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45. The arguments about loss of sovereignty have centred around three major issues. First, how Member States in an economic and monetary union will bring help to depressed areas(1). The Institute of Directors said that "any artificially created monetary area will impose strains on sectors or regions of the economy or economies within that area" (IOD). In particular, Member States will lose the ability to devalue, and therefore to give, at least temporarily, a competitive advantage to its industry (Q 42). The second issue was how far the controls on fiscal and budgetary policy suggested by the Delors Committee would go, and indeed whether any such intervention is necessary. Finally, many witnesses discussed the possible constitution of a European Central Bank.

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(1) See European Communities Committee, 21st Report, 1987-88: European Financial Area (HL Paper 109), paragraph 68.

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Depressed regions in a monetary union

46. Some witnesses argued that the problems of controlling inequalities within a monetary union were such that economic convergence was a prerequisite for moves towards union (see paragraphs 40--1). Even in the United States, convergence was not such that Texas could avoid a recession in the wake of the 1986 oil price shock, whereas the United Kingdom had been able to adjust its exchange rate (Q 65). Others believed that union could act as a motor for convergence, and that as economic interdependence grew, there was less chance that circumstances would affect one region any more harshly than another (QQ 42, 317).

47. But Mr Dixon and Sir Leon Brittan questioned the effectiveness of the devaluation weapon, saying it gave "only the shortest of short-term gains" and merely put off difficult decisions (QQ 317, 448-50). Mr Lilley said it was "not nearly so effective" as its exponents believed; and that if it was important to some Member States, his advice to them

would be to avoid monetary union. Manipulation of the exchange rate could never produce a transfer of resources, and was merely inflationary (QQ 263--4, FC). Mr Leigh-Pemberton accepted that, in certain circumstances, devaluation could soften pressures on the economy. But he was sceptical of its overall value and related that when asked how often Ireland had chosen to devalue the punt, the Irish member of the Delors Committee admitted that it was an unusual expedient (QQ 20, 23).

48. The Delors Committee Report frequently mentions the increased use of the Structural Funds as the steps towards union are taken.(1) Professor Goodhart argued that the Funds were used as a "pork barrel", with money squandered on infrastructure projects with little tangible benefit, and the Institute of Directors said that "increased spending on regional policies could exacerbate rather than enhance regional disparities" (Q 175, p 36, CW, IOD). Mr Lilley argued that decisions on infrastructure were best taken by the Member States (QQ 260, 262--3, 265). But generally witnesses believed that - with the strong proviso that current reforms should ensure that the Funds are well targetted and monitored - the Funds were of value (QQ 69, 135--6, FC, UNICE, JS)

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(1) See European Communities Committee, 14th Report, 1987-88: Reform of the Structural Funds (HL Paper 82).

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49. Whatever the value of the Structural Funds, Mr Leigh-Pemberton, Mr Dixon and Lord Cockfield pointed out that the Funds were not designed to help regions suffering from a sudden shock. The role of the Funds was to act as long-term catalysts, allowing regions to "effect their own salvation" (QQ 20, 133--4, 321--22). Mr Davies thought the Funds "far too small to have any real impact", though Mr Bishop pointed out that in some areas of the Community, receipts from the Funds could amount to between three and six per cent of GDP (QQ 66, 387--9). In the long term, the Funds would support economic and monetary union by encouraging economic convergence. But Member States should not see the Funds in terms of "compensation" for the loss of devaluation (QQ 20, 321). Professor Charles Wyplosz of the European business school INSEAD pointed out that in any case, the targetting of the Structural Funds on poorer regions was not designed to act as such compensation; there should be "no presumption at all that individuals in [poorer] regions stand more to be adversely affected by disturbances normally dealt with

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45. The arguments about loss of sovereignty have centred around three major issues. First, how Member States in an economic and monetary union will bring help to depressed areas(1). The Institute of Directors said that "any artificially created monetary area will impose strains on sectors or regions of the economy or economies within that area" (IOD). In particular, Member States will lose the ability to devalue, and therefore to give, at least temporarily, a competitive advantage to its industry (Q 42). The second issue was how far the controls on fiscal and budgetary policy suggested by the Delors Committee would go, and indeed whether any such intervention is necessary. Finally, many witnesses discussed the possible constitution of a European Central Bank.

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(1) See European Communities Committee, 21st Report, 1987-88: European Financial Area (HL Paper 109), paragraph 68.

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Depressed regions in a monetary union

46. Some witnesses argued that the problems of controlling inequalities within a monetary union were such that economic convergence was a prerequisite for moves towards union (see paragraphs 40--1). Even in the United States, convergence was not such that Texas could avoid a recession in the wake of the 1986 oil price shock, whereas the United Kingdom had been able to adjust its exchange rate (Q 65). Others believed that union could act as a motor for convergence, and that as economic interdependence grew, there was less chance that circumstances would affect one region any more harshly than another (QQ 42, 317).

47. But Mr Dixon and Sir Leon Brittan questioned the effectiveness of the devaluation weapon, saying it gave "only the shortest of short-term gains" and merely put off difficult decisions (QQ 317, 448-50). Mr Lilley said it was "not nearly so effective" as its exponents believed; and that if it was important to some Member States, his advice to them

through the exchange rate than individuals elsewhere". Mr Stevens said that monetary union was an instrument, not a consequence, of economic convergence, so that there was no justification for demands for transfers of resources (CW, JS).

50. Most monetary unions, such as the United States or Canada, have an inbuilt element of regional transfer in taxation and social security policies. Resources are "automatically" transferred as taxation hits the richer areas most heavily, while the poorer areas gain more from social security. Professor Goodhart argued that such a system was the most effective way of helping depressed areas and Professor Wyplosz said that "the Report obviously feared to recognise that the only way to [compensate for the lack of labour mobility] is via a substantially increased federal budget" (QQ 45, 176, CW). But Mr Dixon said that the Commission did not consider such centralisation to be an option. Community expenditure would never rise above four to five per cent of total public expenditure (QQ 279, 318, 484).

Controls on Fiscal and Budgetary policy

51. Perhaps the single most controversial aspect of the Delors Committee Report is its conclusion that monetary union must be accompanied by economic union in the sense of macroeconomic policy coordination (Q 338). This would include binding limits on Member States' budget deficits and on their access to borrowing, together with the "overall stance of fiscal policy in the medium term". Witnesses saw these measures as the proposals most likely to deprive Member States of autonomous power. Mr Banham thought them "unnecessarily *dirigiste*", and Mr Davies said that the Community would be able to dictate national budgetary and taxation policy "in a way that to my knowledge has not occurred before, except under conditions of full political union" (QQ 45, 180, IOD).(1)

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(1) Eltis (*op. cit.*) also expressed scepticism about the ability of "the Commission, or another appropriately delegated authority" (Delors Committee Report, paragraph 33) to ensure that Member States applied the limits.

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52. However, despite the frequency with which the Delors Committee Report comes back to the issue of fiscal and budgetary controls, there seems a lack of clarity about the exact extent of the proposed controls (p 35). The fears of heavy-handed central interference expressed by some witnesses do not square with the some other witnesses' interpretation of the Report. Mr Dixon stressed that whatever institution oversaw these aspects of policy would have little interest in either the size or the composition of either expenditure or revenue. Where they would take a view was on the overall surpluses and deficits (QQ 280--82). Sir Fred Catherwood considered that such a power of "marginal adjustment" could be useful in putting pressure on Member States who, unlike the United Kingdom, did not exercise fiscal restraint; in Lord Cockfield's words, "so that one Member State is not rocking the boat".(1) Mr Pohl, the Governor of the Bundesbank, had supported these restraints to avoid the danger that economic and monetary policy will fall out of step, though Lord Cockfield believed that monetary union would itself encourage the convergence of budgetary policy (Q 101, FC).

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(1) Professor Michael Artis in Brittan and Artis op. cit. pointed out that "it is certainly true that fiscal expansion (or contraction) by a member government in a currency union would have effects on the other members".

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53. Mr Davies, Mr Banham, Professor Wyplosz and ICI believed that in a monetary union, it was in fact particularly vital that Member States retained control of their fiscal and budgetary policy. This would give them some leeway to respond to recession, and budgetary policy within a monetary union would in fact be more effective than at present. Even in the United States and in Canada, let alone under the gold standard, a large degree of budgetary freedom was left to the states and provinces involved (QQ 45, 64, 180, 234, 236, 456, CW).

54. Several supporters of monetary union argued that union would be perfectly workable without such controls. Sir Leon Brittan was convinced that "the degree of central fiscal intervention" envisaged in the Delors Committee Report was not necessary. Informal pressures from other Member States and a prohibition on Central Bank financing of deficits would complement market discipline (QQ 456, 462). In the words of Mr Bishop, "market discipline on budgetary excesses can work

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if that market is properly structured and there are adequate safeguards"; that is, that the markets are given full information, are entirely free to move capital, and are convinced that Member States will not be bailed out. He did accept, however, that such discipline could take several years to have its full effect (QQ 364, 366, 368, 371, 383--4, 490).(1) Governments unable to finance deficits by monetary means would be forced to borrow in the capital markets, and credit ratings would act as an adequate discipline. Mr. Stevens saw a European Central Bank as crucial to the creation of a "market culture" able to make such judgements (JC). Professor Goodhart argued that even if the control exercised by the markets was imperfect, such doubts scarcely justified the "construction of a vast edifice of centralised fiscal control". He suggested that if some controls were deemed essential, alternative solutions did exist, such as surcharges on those who failed to meet their debt obligations. ICI said that, with money creation in the hands of a European Central Bank, market discipline would in fact be more effective than the proposed limits (QQ 52, 65, 162, 165, 235, p 35, CW). Mr Leigh-Pemberton was sceptical, fearful that removing the institutional safeguards proposed in the Report would leave the system vulnerable to "to attacks by the market or to a loss of nerve by individual governments" (Q 29).

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(1) In An Evolutionary Approach to Economic and Monetary Union, the Government have argued that the discipline of the capital markets and an agreement that Member States running excessive budget deficits would not be bailed out will impose budgetary restraint on governments irrespective of the existence of fixed exchange rates. The paper also points to some of the practical obstacles to setting binding limits.

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Institutional aspects of economic and monetary union

55. The Delors Committee Report proposes a "European System of Central Banks" (ESCB) for Stage Three. The ESCB would determine monetary policy and manage the Community currency's exchange rate with third countries.(1)

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(1) In Macroeconomic Policy Coordination and the European Monetary System (CEPR, September 1989), Professor Richard Portes has stressed the importance of "fashioning and implementing appropriate strategies in [the] global context - agreed EC external macroeconomic policies" - because "tighter economic integration will make uncoordinated responses to external (from outside the EC) shocks more costly".

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56. The main objection to the ESCB was that the institution responsible for determining the Community's monetary policy would not be democratically accountable. Mr Davies thought that once one began to think in terms of a separate European Central Bank, "we start to step into the area where we need political union to make it work" (Q 47).

57. Most witnesses considered that the most successful monetary policy in Europe has been that of the West German Bundesbank. The members of the Bundesbank are appointed by the West German government, but the Bank's daily activities are conducted independently of government interference and the Bank has a constitutional responsibility to keep price stability as its first priority. Mr Davies argued that "the best system that Western Europe has available" would be to build upon the existing success of the Bundesbank. There would be no European Central Bank - Member States would lock their currencies onto the deutschmark and rely on the Bundesbank to continue its recent success. Indeed, Professor Goodhart recommended that the United Kingdom should take this step immediately. He thought that the Bundesbank could gradually take on a more internationalist flavour, finally re-constituting itself as the ESCB. But Mr Davies did admit that it might be politically impossible for Member States to give up all say in monetary policy, and feared that tacking representatives from other states onto the Bundesbank would merely reduce its credibility (QQ 47--50, 53--54, pp 31, 39, FC).

58. Many witnesses were attracted by the Bundesbank's independence, with the British Bankers' Association "strongly supporting" the proposal to make the ECSB autonomous. Indeed, Mr Stevens said that "an independent central bank is as crucial to a free market economy as an independent judiciary to an open society". He argued that it should in fact have more independent powers than either the US Federal Reserve or the current Bundesbank (JS). But any attempt to emulate the Bundesbank's success - and therefore its independence - runs into the problem of accountability. Mr

Leigh-Pemberton acknowledged that a Central Bank needed to give forceful advice to governments - even, on occasions, to resist them - but said that "a great deal more work had to be done" on reconciling the need for an independent Central Bank with the need for democratic accountability (QQ 21, 27, 144, 338, 361, 464). Professor Goodhart thought that the Reserve Bank of New Zealand could point the way towards such a reconciliation (Q 177). But the Institute of Directors thought that independence and adequate accountability were incompatible. The conditions which made the Bundesbank's independence acceptable could not be imitated on a Community scale (IOD).

59. Mr Dixon accepted that the Delors Committee Report had raised fundamental political and institutional questions, which was why it had highlighted the need for an amendment to the EEC Treaty.(1) But he also pointed out that Member States could have more actual power in a monetary union than at present. The fact that most Member States, including the United Kingdom, had been forced to follow the Bundesbank in raising interest rates in October 1989 illustrated the reality that their room for manoeuvre was slight (QQ 283--5, 292--4, 309, 339). In Sir Fred Catherwood's words, "most states believe that the theoretical loss of sovereignty is substantially outweighed by the decisive increase in real collective power" (FC).(2)

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(1) President Delors, in a speech to the College of Europe in Bruges (17 October 1989), described economic and monetary union as "the interface between economic integration and political integration".

(2) Eltis (op. cit.) drew attention to differences of emphasis and opinion in Europe on this issue, concluding that "it would ... be a considerable error to take it for granted that the ESCB would act with the financial conservatism that the Bundesbank has demonstrated in the management of the European Monetary System". See also European Communities Committee, 21st Report, 1987-88: European Financial Area (HL Paper 109), paragraph 66.

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60. The proposed constitution of an ESCB is of obvious significance in the search for a balance between independence and accountability. Mr Dixon believed that the chairman of the Bank should be entitled to sit in Council meetings, and that scrutiny of the Bank should not be entirely

retrospective. The Bank's constitutional requirement to pursue price stability would have to be seen in the context of the Community's overall economic objectives. Lord Cockfield considered that democratic accountability could be exercised through the appointment of the Bank's members, but Professor Wyplosz thought that it would require a stronger Parliament. Mr Stevens proposed that the European Parliament should have a "reserve power" over the Bank, exercised largely through ratification of its membership. His model was Congress' scrutiny of the US Federal Reserve (QQ 82--4, 146--150, 300--1, 469-70, 472--5, VDK, FC, CW, JS).

The threat of a two-tier Europe

61. Most major policy developments in the Community have been accompanied by fears that the policy will be unable to carry unanimous support, and that the Member States will split into a "two-tier" Europe.(1) Mr Leigh-Pemberton admitted that on the Delors Committee itself, there had been something of a split between the "idealists", confident that union was the way forward for the Community, and the "pragmatists", who preferred to take a step-by-step approach (QQ 1, 27). Mr Lilley and Mr Davies both doubted that calls from some Member States for action would be matched by the political will required (QQ 61, 230, 244--5).

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(1) The Opinion of the Section for Economic, Financial and Monetary Questions of the Economic and Social Committee (October 1989) considered this a real possibility, although expressing a strong preference for all Member States to move forward simultaneously.

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62. All witnesses agreed that such a division would be undesirable, both for the United Kingdom and for the other Member States (QQ 27, 129, 209, 243, 271, 349--50, 492, BBA). Mr Leigh-Pemberton had been pleasantly surprised at the "constructiveness and realism" of the Madrid summit, which was in line with United Kingdom interests (Q 1). But Sir Fred Catherwood was convinced that, although the involvement of sterling would undoubtedly be an asset, "whether or not Britain joins, the European Community will go ahead with monetary union" (Q 492, FC).

63. In particular, there were fears that it might be especially damaging for the United Kingdom to be found in a second tier. The importance of the City of London was such

that the economy of the whole United Kingdom could suffer if the City lost out to rival financial centres within [illegible] currency union. Mr Stevens said that "it is difficult to imagine ... the present status of the City as a financial centre long surviving any failure by the United Kingdom to participate fully in a move to European monetary union". The United Kingdom were in danger of "shooting themselves in the foot" (Q 479, JS). Lord Cockfield said that monetary union would be an "unparalleled opportunity" for the United Kingdom financial services industry (Q 151). A subsiduary issue was the location of the Bank. The British Bankers' Association called on the Government to "assign priority" to ensuring that the operational wing of any European Central Bank would be in London (BBA). Mr Leigh-Pemberton said that London would certainly be the obvious site for any Bank. But he "would be very disappointed if in some way we so drag our feet that we were affecting the position of London as a financial centre", although he added that "we are a long way from that at present" (QQ 35--36, 480--1).

64. But Mr Davies doubted that London would suffer in such circumstances. Whatever its impact on the wider economy, an unstable currency could be a source of profit for the financial markets. In any case, most international financial institutions based in London used instruments based on the dollar or the yen. The City had built up an expertise that would always be in demand (QQ 87, 91--4). However, Mr Davies joined Mr Banham in fearing that if the United Kingdom failed to "buy a seat" in negotiations over monetary union, it might lose its influence on the structure of the system. Mr Stevens said that the United Kingdom currently had a "semi-detached status" in the debate. Sir Leon Brittan predicted that United Kingdom membership of the ERM would increase its influence on future progress "out of all proportion" (QQ 87, 190, 464, 492, JS).

## PART 3 OPINION OF THE COMMITTEE

65. In considering the Delors Committee Report, the Committee believe that it is important to bear two political realities in mind. First, the Member States have committed themselves to some form of economic and monetary union - not specifically defined - by ratifying the Single European Act and by successive declarations from the Heads of Government. Second, political pressure has built up in support of making progress towards this objective in the 1990s. Any assessment of the options open to the Community, and to the United Kingdom, must take these factors into account.

### The European Monetary System and Stage One

66. Over many years, the Committee have consistently made it clear that they support United Kingdom membership of the Exchange Rate Mechanism (ERM) of the European Monetary System.(1) This would reinforce the Government's goals of low inflation and a stable macroeconomic environment. At present, the United Kingdom can use interest rates for domestic purposes and let the exchange rate find its own level, or can set interest rates with exchange rate objectives as the priority. As a member of the ERM, the United Kingdom would lose this option. A stable exchange rate would be the aim.

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(1) European Communities Committee, 5th Report, 1983-84: European Monetary System (HL 39); European Communities Committee, 21st Report, 1987-88: European Financial Area (HL Paper 109).

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67. At the Madrid summit, the Government reaffirmed its commitment to become a full member of the EMS. This means joining the ERM. They explained that sterling would join the ERM once three conditions had been met; United Kingdom inflation must have fallen, the present members of the ERM must have successfully accommodated the free movement of capital, and a Single Market in financial services must have been substantially completed. Obviously all of these conditions are open to shades of interpretation. The Committee's opinion is that none of them presents a serious obstacle to joining the mechanism soon. They recognise that to join with inflation on the rise could be dangerous, but inflation in the United Kingdom appears to have passed its

peak and to be falling. The weight of evidence also suggests that ERM membership itself would assist other anti-inflationary pressures. The Committee were also impressed by the view of many witnesses that any destabilisation resulting from the freedom of capital movements will be minor and that Member States committed to the system will be able to cope. The Committee agree with the conclusions of the Madrid summit that progress towards the completion of the Single Market is now irreversible, and therefore conclude that free trade in financial services will indeed be established.

68. The Government's conditions assume that the decision to join the ERM will be made on economic grounds. But the Committee consider that the political argument is just as strong, if not stronger. It was clear from the evidence received that the issue of ERM membership has taken on great symbolic significance. United Kingdom membership would be a clear statement that this country is fully committed to the Community. Last year, the Committee recommended that the United Kingdom should take any early opportunity to join the ERM. The Committee consider that negotiations on economic and monetary union will intensify as July 1990 approaches, and believe that to secure an appropriate influence in them, as well as to end damaging speculation about United Kingdom monetary intentions, sterling should join the exchange rate mechanism before that date.

69. The Committee believe that the ERM will survive any stresses likely in the coming years, and that the changes envisaged for Stage One, which include the completion of the 1992 programme, are extremely far-reaching. They therefore do not consider that the Community should be forced into a premature jump to full economic and monetary union. Indeed, they believe it would be wise to wait until the Single Market is fully operational before finally deciding upon the form of the Community's economic and monetary union. The Committee accept that the political momentum is likely to lead to an inter-governmental conference some time in 1990, to consider further steps beyond Stage One. There will be many important questions to address in the light of the financial and economic effects of Stage One, and the momentous political developments in Eastern Europe will have to be taken into account.

## Economic and Monetary Union: Stages Two and Three

70. Stages Two and Three of the Delors Committee Report are concerned with establishing economic and monetary union. Current discussions are hamstrung by confusion about the definition of such a union. A clear definition of economic union would require an institutional framework. Some

witnesses assumed that economic and monetary union could only come about with the full application of the Delors Committee Report, even though the authors themselves accept that the proposals for Stages Two and Three are open for discussion. But most witnesses were clear that monetary union must mean, at the very least, fixed exchange rates and a common monetary policy. The Treasury's "alternative" proposals do not fall within this definition. Nevertheless, they are to be welcomed for their positive attitude to Stage One and particularly to the entry of sterling into the ERM. At this stage it is not possible to say which aspects of the subsequent developments envisaged in the Delors Committee Report will offer the most appropriate form of further progress towards economic and monetary union. However, Member States will be expected to take a positive attitude to future progress, and the Government will need to take this into account in determining its own attitude.

71. The basic arguments for economic and monetary union are that it would provide additional economic gains. First, economic and monetary union can be seen as the logical outcome of success in achieving exchange rate stability. Transaction costs and the risks that accompany currency fluctuations are felt by many European businessmen to put the Community at a competitive disadvantage. The advantages of eliminating these have been well rehearsed. But the Committee consider that such gains could be achieved without adopting the proposals in the Delors Committee Report, by strengthening and developing the EMS. However in the long run, exchange rate stability may well be harder to maintain without an institutional framework.

72. The second main argument is that economic and monetary union, particularly in the form of a common currency, is necessary to exploit the gains of the Single Market to the full. The Committee consider that this is the strongest argument for union. It would serve to underpin the 1992 programme not merely by reducing the costs and risks of transacting across Member States, but also by helping to break down the psychological and administrative barriers which remain the greatest obstacle to a fully successful Single Market. A common European currency would be an enormous step towards the Community's goal of joining the leading rank of world economies.

73. The Committee accept the potential economic gains of economic and monetary union. But the political implications are also central to any decision. At some stage, the Community will have to face a key question - how to achieve the economic advantages of economic and monetary union without jeopardising Member States' say over domestic policy. The exact constitution of an economic and monetary union and

of institutions such as a European Central Bank is absolutely critical. It could affect the structure of the Community's central institutions, as well as their relationship with the Member States. It is essential to be satisfied that adequate safeguards for democratic accountability, both national and European, are built in, appropriate to each institution. And as the Committee have already made clear, such decisions should not be taken until the fundamental changes envisaged for Stage One have been seen to be successful.

74. However, some of the issues which will determine the extent to which Member States would have to cede power to collective decision-making and accept an increased role for Community action have already emerged. There have been calls for increased Structural Funds to compensate depressed regions in an economic and monetary union. The Committee has already expressed its conviction that, properly administered, the Funds should play a key role in improving the economic performance of the less developed areas of the Community.(1) But the connection between the Funds and economic and monetary union is unclear. There seems little reason why any harmful effects of monetary union, at any rate, should fall only on those regions of the Community eligible for aid from the Funds. Their main aim is to develop the long-term potential of such regions, not to provide short-term adjustment or compensation.

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(1) European Communities Committee, 14th Report, 1987-88: Reform of the Structural Funds (HL Paper 82), paragraph 74.

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75. If the Community chose to give aid to regions in difficulty, it would probably have to emulate the invisible and automatic fiscal transfers which operate in successful monetary unions such as the United States. This would require a common federal tax system. But at present, the European Community budget is miniscule in comparison to the United States federal budget, and there are no proposals to transfer power over tax and social security to the Community.

76. One answer to the anxieties of Member States fearful of recession is that in a fully integrated market, the chances of one region being hit by a recession which others escape is reduced. Another is that the completion of the Single Market will be accompanied by increased mobility in the labour market, though this is unlikely to be dramatic enough to stave off recession. The best safeguard however would be for

Member States to retain control over fiscal policy. Their freedom of action would not be unlimited. For example, the free movement of people and capital in the Single Market will discourage governments from setting excessive tax rates.

77. The Delors Committee's proposals to place limits on budgetary and fiscal policy therefore seem unwise and are not justifiable. They are unwise because they will hamper national freedom of manoeuvre when it is most needed; and they are also unnecessary. The aim of binding limits would be to prevent governments pursuing profligate budgetary policies which might have inflationary effects on the common monetary policy. But such dangers might be limited by ensuring that the Central Bank does not finance national budget deficits. A broad convergence of budgetary policy will in any case be encouraged by the operation of market forces. And any Member States behaving in a way which could be interpreted as profligacy would be subjected to great pressure not to do so by the other members.

78. The constitution chosen for a European Central Bank or a European System of Central Banks would clearly have consequences for the balance of power within the Community. The fear expressed in evidence was that it would be difficult to ensure a proper balance between independence and democratic accountability.

79. This cannot be considered without bearing in mind the limits on Member States' freedom of action, including that of the United Kingdom, which will occur as Stage One progresses. With movements of capital liberalised, individual countries will have little monetary autonomy if they are to defend their currencies within the ERM bands. Unless intervention funds are massively increased, domestic interest rates will have to be used to pursue exchange rate targets. For the foreseeable future, effective power will remain largely in the hands of the Bundesbank, because of the current strength of the West German economy, the basis of the deutchsmark's importance both within the ERM and as a global currency. However, collective decision-making in a European Central Bank would in fact increase other Member States' influence over policy.

80. A European Central Bank would be an independent institution in the sense that Member States' governments would have no direct say in the Bank's day to day operations. The real issue is the extent to which the Member States could or should determine the policy guidelines within which the Bank would have to operate. Decisions about where the balance between close democratic scrutiny and operational freedom should lie are very fine, and could only be made once the form of union is determined in far more detail. Economic

logic will encourage the setting up of a European Central Bank, sooner rather than later. But the political implications are far from being acceptable at present to a number of Member States.

Conclusion

81. The Community must not be rushed into an unsatisfactory form of economic and monetary union as a result of short-term pressures. It is vital that the Community gets such fateful decisions right. Current developments in Eastern Europe and in the relationship between the superpowers make it certain that the Community will face new challenges in the coming years. It can best prepare itself for such challenges by developing as a soundly-based economic grouping. This will also help the development of political cooperation between the Member States, as set out in the Single European Act. Economic and monetary union will play a key role in this process. With proper safeguards for democratic accountability, a common currency would bring enormous economic gains. But a satisfactory form of union can best be assured by waiting for proof that Stage One is a success.

82. To protect the United Kingdom's own interests, both economic and political, the Committee believe that it is imperative to play an active role, first in the full implementation of Stage One and then in pressing for further progress. The need for the United Kingdom to convince its Community partners of its European credentials is more important than ever. This can only be achieved by joining the ERM soon, and the Committee suggest before July 1990. The United Kingdom could then play its proper part in shaping the future of the Community, and probably of Europe as a whole. In many aspects of the 1992 programme, the United Kingdom has shown an example to the rest of Europe, and has had a considerable influence on the evolution of Single Market legislation. But by appearing reluctant to participate fully, the United Kingdom can only jeopardise its chances of having a continuing and significant influence on the form of the Community's economic and monetary union.

Recommendation

83. The Committee consider that the Delors Committee Report raises important questions to which the attention of the House should be drawn, and they recommend the Report to the House for information/debate.