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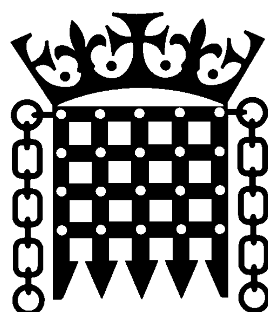

This Paper updates previous Library Papers that dealt with the economic and monetary union provisions of the Maastricht Treaty. It describes the political and economic history of previous European attempts at closer monetary integration. It summarises recent comment in the UK and elsewhere in Europe, concerning the future prospects for EMU, especially in light of the crisis in the exchange rate mechanism in 1992 and 1993. Lastly it indicates the practical steps that are currently being proposed to bring the single currency into everyday use throughout the European Union.

Timothy Edmonds
Economic Policy & Statistics Section

House of Commons Library

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CONTENTS

	Page
I. Introduction	1
II. The moves towards monetary integration	1
III. 'Maastricht' and the United Kingdom's 'opt-out'	6
IV. The economic arguments for a single currency	16
V. The ERM crisis & prospects for the future	26
VI. The state of convergence	36

I. Introduction

For more than twenty years European politicians and bureaucrats have harboured dreams of closer monetary integration between their respective national economies. Some were attracted by the idea of forming an alternative force to counter the influence of the world's dominant currency, the US dollar. Some have been attracted by the advantages that a single currency would bestow. Others, have argued for it on the grounds of political symbolism, whilst yet others have seen it as a way to import an economic model that has worked successfully in the major economy of Europe: Germany. Over the course of this period, enthusiasm has waxed and waned, different priorities have emerged and doubts have crept in about some of the benefits. Furthermore, politicians in several countries have been forced to realise that, first, they may be ahead of their electorates in their enthusiasm for change and, secondly, that cherished political dreams have to accommodate market realities.

This Paper briefly outlines the history of past attempts at achieving monetary integration and looks at the supposed benefits. It then turns to the current institutional framework for integration, the Maastricht Treaty, and looks at how the provisions of the treaty can adapt to economic conditions in Europe after both a deep recession and the 'collapse' of the exchange rate mechanism (ERM) in 1993.

II. The moves towards monetary integration

The histories of attempts by Member States to move closer together and towards some kind of monetary union frequently start in October 1970 with the publication of the Werner Report. The Report, under the Chairmanship of the then Prime Minister of Luxembourg, Pierre Werner, was a response to German and French initiatives to reestablish control over their respective economies following disruptive events in the late 1960s which culminated in the devaluation of the franc in 1969. The Report proposed a full EMU to be achieved by a target date of 1980. The Union was to achieve the 'total and irreversible convertibility of currencies, the elimination of fluctuation in exchange rates, the irrevocable fixing of parity rates and the complete liberation of movements of capital'.

In comparison to the Maastricht Treaty the Werner plan paid little attention to the institutional requirements of the union, it paid less attention to the subject of economic convergence, and paid more attention to economic control at the Community level and even introduced some potential scope for a joint incomes policy. The Report was endorsed at an ECOFIN Council meeting in Paris and the process leading to the completion of Stage 1, which was to end in 1973 was begun. The process also received political endorsement from the then new entrant

members, Ireland, Denmark and the UK. This endorsement was easy to give since progress on the first two stages of the plan relied entirely upon the voluntary coordination of national economic policies. It was a mortal blow to the Werner Plan that only five months after it received political affirmation, the Bretton Woods system, which then underpinned the world currency markets, collapsed following the devaluation of the US dollar in August 1971. This effectively scuppered the chances for the plan to survive intact, however, some elements survived in the establishment of the 'Snake' in 1972.

European leaders discussed monetary arrangements at a summit in Paris in October 1972 which was principally aimed at the question of Community enlargement. The outcome of the Summit was reported to the House in a statement by the then Prime Minister, Mr Heath[1], who declared that the purpose of the meeting:

> "was to set the course for the development of the enlarged Community. We thought it right to establish the broad principles on which this development should be based....The main decision of the summit conference was that the Member States...affirmed their intention to transform the whole complex of their relations into a European Union by the end of the decade...The enlarged Community reaffirmed its determination to progress towards economic and monetary union; and it was fully accepted that progress in economic cooperation must move in parallel with progress in monetary cooperation."

With regards to monetary union the Prime Minister said that:

> "the meeting agreed on the need for Community mechanisms to defend the fixed but adjustable parities between member countries' currencies which will be an essential basis for economic and monetary union....the Community should move to the second stage of economic and monetary union on 1st January 1974, with a view to its completion by the end of this decade"[2]

From this declaration a system which came to be called the 'Snake within the (dollar) tunnel' emerged. Under the monetary regime which superseded Bretton Woods, the Smithsonian agreement in 1971, European currencies could move bilaterally against each other by up to 9%. In Europe, however, it was felt that 9% was too big a margin to accommodate the workings of Community institutions, such as the CAP. The Snake reduced the inter-European currency variations to 4.5%. When the dollar was floated in March 1973 the 'tunnel' effectively disappeared and all that remained was an intra-European exchange rate agreement which was seen as a precursor of the European Monetary System which took over in 1979. The UK joined the 'snake' with Denmark on 1st May 1973 but left on the 23rd June following a short foreign exchange crisis.

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[1]HC Deb 23 October 1972 c791

[2]op cit c792

Throughout its seven year history there were many revaluations of the parities and permanent or temporary exits from the mechanism. Italy withdrew in 1973, and, after leaving and then rejoining once, France withdrew finally in 1976. The non-Member States of Sweden and Norway associated their currencies with the system but were also forced to withdraw in 1977 and 1978 respectively. The DMark was revalued three times and there were twelve other instances of currencies changing their rates. By its end it:

> "operated as a liberal version of the Bretton Woods system in its final years....But these final years of the snake at least succeeded in putting moderate use of exchange rate changes as an instrument of adjustment back on the policy agenda, hence avoiding the two extremes of either regarding exchange rates as untouchable, because their stability was part of a fixed rate orthodoxy, or as market determined." [3]

What did emerge with some force was that European countries' currencies outside of the snake (especially the lira and sterling) were susceptible to far greater pressure than those within it.

Although it could be said that the Snake had not operated as had been intended, with the absence of France, the UK and Italy, Germany economically dominated the 'union', it was primarily political factors, rather than economic necessity, which initiated the negotiations that were to lead to the creation of the European Monetary System in 1979.

German willingness to support moves towards greater union were enhanced by several events in the late 1970s. First, the prospect of increased political stability in France following the national election in 1978 and the introduction of the 'Barre' plan to bring about economic stability. Secondly, Germany was concerned about the growing influence of the Communist party in Italy, and sought to find ways in which to provide economic support for the country. Lastly, there was a desire in Germany to decouple from the increasingly unstable US dollar. A collapse in the value of the dollar worldwide could be expected to result in an increase in the attractiveness of the DMark and would encourage the currency to appreciate even further. The twin aims of European stability and insulation from the dollar were attractive to Germany. But how were these aims to be translated into policy? From the start, negotiations were between the majority group of countries who had managed to remain in the Snake, and who felt that they had played by the rules, and a smaller group of countries, the UK, France and Italy who by their sheer size would be very important to any closer European arrangement.

Simultaneous to these developments was the accession to the Commission Presidency of Lord (Roy) Jenkins. In a series of speeches in the course of 1977, he relaunched the idea of monetary union. Alongside this was a call for greater fiscal powers for the Commission. When the ideas were presented at the next ECOFIN and Council meetings at the end of 1977,

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[3] 'European Monetary Integration', p 19, Daniel Gros & Niels Thygesen

although the ideas for fiscal federalism were rejected, the bold plans for monetary union remained on the table. They were extended by a joint French-German initiative which was submitted to the European Council Meeting in Copenhagen in April 1978. This devised an objective trigger for automatic policy coordination and intervention obligations for all Member States to defend their intra EC exchange rates. This initiative was extended following Council meetings in Bremen and Brussels during 1978. The Annex to the declaration at Bremen in July 1978 said that:

> "In terms of exchange-rate management the European Monetary System (EMS) will be at least as strict as the 'Snake'. In the initial stages of its operation and for a limited period of time member countries currently not participating in the snake may opt for somewhat wider margins around central rates. In principle, interventions will be in the currencies of participating countries. Changes in central rates will be subject to mutual consent. Non-member countries with particularly strong economic and financial ties with the Community may become associate members of the system. The European Currency Unit (ECU) will be at the centre of the system, in particular, it will be used as a means of settlement between the EEC monetary authorities.
>
> An initial supply of ECUs (for use among Community central banks) will be created against deposit of US dollars and gold on the one hand (e.g., 20 per cent of the stock currently held by member central banks) and member currencies on the other hand in an amount of a comparable order of magnitude.The use of ECUs created against member currencies will be subject to conditions varying with the amount and the maturity; due account will be given to the need for substantial short-term facilities (up to one year).
>
> Participating countries will coordinate their exchange-rate policies vis-a-vis third countries. To this end they will intensify the consultations in the appropriate bodies and between central banks participating in the scheme. Ways to coordinate dollar interventions should be sought which avoid simultaneous reverse interventions. Central banks buying dollars will deposit a fraction (say 20%) and receive ECUs in return; likewise, central banks selling dollars will receive a fraction (say 20%) against ECUs
>
> Not later than two years after the start of the scheme, the existing arrangements and institutions will be consolidated in a European Monetary Fund.
>
> A system of closer monetary cooperation will only be successful if participating countries pursue policies conducive to greater stability at home and abroad; this applies to the deficit and surplus countries alike."

The functioning of the EMS/ERM deserves a Paper to itself, however, in brief, the experience of the system was that it moved from a loose grouping of currencies and economies to an ever more rigid system of currency management with fewer and fewer realignments. With

this development there was also a general convergence of the monetary variables of the Member Sates such as inflation and interest rates. The system was not without criticism, however, and this was forcefully put by the French Finance Minister Edouard Belladur in a memorandum in January 1988. Part of this is reproduced below:

> "Ultimately it is the central bank whose currency is at the lower end of the permitted range which has to bear the cost. However, it is not necessarily the currency at the lower end of the range which is the source of the tension. The discipline imposed by the exchange-rate mechanism may, for its part, have good effects when it serves to put a constraint on economic and monetary policies which are insufficiently rigorous. It produces an abnormal situation when its effect is to exempt any countries whose policies are too restrictive from the necessary adjustment. Thus the fact that some countries have piled up current account surpluses for several years equal to between 2 and 3 per cent of their GDPs constitutes a grave anomaly. This asymmetry is one of the reasons for the present tendency of European currencies to rise against the dollar and the currencies tied to it. This rise is contrary to the fundamental interest of Europe and of its constituent economies. We must therefore find a new system under which this problem cannot arise."[4]

This criticism was aimed at Germany, where the Bundesbank-determined monetary policy, increasingly determined the economic condition of the EMS. Criticisms of this sort were echoed by the Italian authorities who claimed that "the German external surplus had become so structural [an undervalued DMark] so as to remove growth potential from other countries". The German Finance Minister -Genscher- responded with his own memorandum. Entitled 'A European Currency Area and a European Central Bank' it stated that a single currency and a central bank would be catalysts to bring achieve the necessary convergence of economic policies of Member States without which monetary union could not exist. Events proceeded quickly and at the European Council meeting at Hanover in June 1988 it was:

> 'decided to entrust to a committee the task of studying and proposing concrete stages leading to this union. The Committee will be chaired by Mr Jacques Delors, President of the European Commission'

The Committee was to Report back in time for the Council meeting in Madrid the next year.

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[4]Quoted in European Monetary Integration, Gros & Thygesen p313

A full description of the Delors report[5] has appeared in an earlier Library Paper[6] and it is only necessary to highlight a few relevant points here.

The Report highlighted and maintained that there was a fundamental and necessary link between the economic union, the drive towards the Single Market, and monetary union. This linkage was very controversial and successive UK governments have tried to maintain a distinction between the two. The Report outlined a three stage process moving from the existing EMS structure to full union in stage three. It accepted that it would be possible to have a complete monetary union without a common European currency. However, "a single currency would clearly demonstrate the irreversibility of the move to monetary union, considerably facilitate the monetary management of the Community and avoid the transactions costs of converting currencies."

The Delors Report was discussed at the Madrid summit in June 1989 and the Government's response was made in a statement to the House by the then Prime Minister, Margaret Thatcher[7].

On the basis of the Report, the Commission staff fleshed out the final proposals for EMU which eventually became the Maastricht Treaty.

III. 'Maastricht' and the United Kingdom's 'opt-out'

A. Introduction

For the movement to full EMU to succeed with the minimum of economic and political 'pain', the Community intended to move in measured steps or phases, each one building upon and consequent upon, the successful completion of the previous phase by all, or by a majority of Member States. Since January 1st, 1994, the Union has been in stage two of this process.

The Maastricht Treaty[8] outlines the future path towards full economic union, and tries to avoid the experience of German reunification, which shows just how painful immediate union can be despite the massive initial political will in support of it. During each phase the Treaty addressed itself to two considerations. First, the economic policy and behaviour of Member

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[5]The Report on Economic and Monetary Union in the European Community (12/4/89)

[6]Background Paper 233

[7]HC Deb 29/6/89 c1107

[8]Treaty on European Union Cm 1934

States - 'convergence'. Secondly, the provision of an institutional framework adequate to meet the economic, political and administrative demands that EMU will undoubtedly bring. Alongside this procedure, the Treaty also contained various provisions and derogations applying to individual countries. Of the greatest importance of these to this country is the UK's 'opt-out'.

Hereinafter all references will be to articles in the Treaty unless otherwise stated in the text.

B. Economic policy

Article 3a establishes certain principles which Member States will be required to follow and lists the ways in which the general objectives "close co-ordination of Member States' economic policies" etc, will be achieved:

> these activities shall include the irrevocable fixing of exchange rates leading to the introduction of a single currency, the ECU, and the definition and conduct of a single monetary policy and exchange rate policy the primary objective of both of which shall be to maintain price stability and..the general economic policies in the Community

This is elaborated by article 103 which outlines the role that the European Council expects to play in the general formulation of Member States' economic policy:

> The Council shall, acting by a qualified majority on a recommendation from the Commission, formulate a draft for the broad guidelines of the economic policies of the Member States and of the Community, and shall report its findings to the European Council.
>
> The European Council shall, acting on the basis of this report from the Council, discuss a conclusion on the broad guidelines of the economic policies of the Member States and of the Community.

and

> In order to ensure closer co-ordination of economic policies and sustained convergence of the economic performances of the Member States, the Council shall, on the basis of reports submitted by the Commission, monitor the economic developments in each of the Member States and in the Community as well as consistency of economic policies with the broad guidelines referred to in the preceding paragraph, and regularly carry out an overall assessment.

The Treaty deals in turn with fiscal and monetary policy.

1. Fiscal policy

Article 104c is explicit: "Member States shall avoid excessive government deficits"[9]. It is important to note however that this paragraph does not apply until Stage 3. In Stage 2, i.e. from 1 January 1994, Member States have a rather lower target to meet in that "Member States shall *endeavour* to avoid excessive government deficits"[10]. Article 104c (2) and its relevant Protocol define excessive deficits in the following two ways:

> - whether the ratio of the planned or actual government deficit to gross domestic product exceeds 3% and, if so,
>
>   - whether the ratio has not declined substantially and continuously and has not reached a level that comes close to 3%;
>   - or, alternatively whether the excess over 3% is only exceptional and temporary and the deficit remains close to 3%;
>
> - whether the ratio of government debt to gross domestic product exceeds 60%, and if so, whether the ratio is not sufficiently diminishing and not approaching 60% at a satisfactory pace.

The provisions concerning failure to meet these objectives are set out in the remaining sections of article 104c and are progressively more serious. They start with article 104c (3):

> If a Member State does not fulfil the requirements under one of these criteria, the Commission shall prepare a report. The report of the Commission shall also take into account whether the government deficit exceeds the government investment expenditure, and take into account all other relevant factors, including the medium term economic and budgetary position of the Member State.

If a Member State looks to be in danger of failing to meet the criteria there then follows a long drawn out procedure of ever-increasing severity. The Commission prepares a report on the Member State involved. A Monetary Committee,[11] appointed by Member States and the Commission, formulates an opinion on the Commission's report. If it feels it to be necessary, the Commission reports to the Council who can, first, make private recommendations and, then public recommendations about the failures of the Member State concerned. If a Member

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[9]article 104 c (1)

[10]article 109 e (4)

[11]article 109 c (1)

State persists in failing to put into action the recommendations of the Council, the Council may decide to give notice to the Member to take specified measures to remedy the situation[12]. The ultimate sanction is set out in article 104c 11. It is shown below:

> As long as a Member State fails to comply with a decision taken in accordance with paragraph 9, the Council may decide to apply or, as the case may be, intensify one or more of the following measures:
>
> - to require that the Member State concerned shall publish additional information, to be specified by the Council, before issuing bonds and securities;
> - to invite the EIB to reconsider its lending policy towards the Member State concerned;
> - to require that the Member State concerned makes a non-interest-bearing deposit of an appropriate size with the Community until the excessive deficit has, in the view of the Council, been corrected;
> - to impose fines of an appropriate size.

2. Monetary policy

From 1 January 1994, all restrictions on the movement of capital and payments between Member States and Member States and third countries, were abolished[13]. Although those countries which are entitled to have capital controls up to 31 December 1993 may maintain them until 31 December 1995 (but not reintroduce them if they have already been abolished). Member States also committed themselves to the progressive abolition of all restrictions on the payment for goods and services between States.

Member States will, by virtue of article 73 d however, be able:

> - to apply the relevant provisions of their tax law which distinguish between tax-payers who are not in the same situation with regard to the place of residence or the place where their capital is invested;
> - to take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation and the prudential supervision of financial institutions, or to lay down procedures for the declaration of capital movements for purposes of administrative or statistical information, or to take measures which are justified on grounds of public policy or public security.

[12]article 104 c (9)

[13]article 73 b

This section of the Treaty also establishes the broad framework of the new institutions which will assume such importance in Stages 2 and 3.

C. Institutional developments

1. Stage Two

i. Monetary Committee

One role for the Monetary committee has already been mentioned - the monitoring of Member States' budgetary performance. In addition it can deliver opinions to the Council or Commission on its own initiative or at their request and, at least once a year, it will look at the position regarding the freedom of movement of capital between States. Its membership includes two representatives from each state and two from the Commission[14].

ii. European Monetary Institute (EMI)

The EMI is established by article 109f (1) "at the start of the second stage" and takes over from the Committee of Governors. The EMI is an embryonic European Central Bank and hence the tasks assigned to it are similar, although they are applied to the specific circumstances of the transitional stage two. The work of the EMI is outlined below:

> The EMI, shall:
>
> - strengthen co-operation between the central banks of the Member States;
> - strengthen the co-ordination of the monetary policies of the Member States with the aim of ensuring price stability;
> - monitor the functioning of the European Monetary System;
> - hold consultations concerning issues falling within the competence of the central banks and affecting the stability of financial institutions and markets;
> - take over the tasks of the European Monetary Co-operation Fund which shall cease to exist;
> - facilitate the use of the ECU and oversee the development, undertake functions with respect to the ECU clearing in the private markets, including the smooth

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[14] article 109 c (1)

functioning of the ECU clearing system.

For the preparation of the third stage the EMI shall:

- prepare the instruments and the procedures necessary for carrying out a single monetary policy in stage three;

- promote the harmonisation, where necessary, of the conditions governing the collection, compilation and distribution of statistics in the areas within its field of competence;

- prepare the rules for operations to be undertaken by the national central banks in the framework of the ESCB;

- promote the efficiency of EC cross-border payments;

- supervise the technical preparation of ECU banknotes.[15]

The EMI began its operations in Basle but held its inaugural meeting in its permanent home in Frankfurt on the 11th January 1994[16]. The President of the EMI is Alexandre Lamfalussy, former Irish Central Bank Governor Maurice Doyle was nominated as Vice-President.

2. Stage Three

i. European System of Central Banks [ESCB]

The "primary objective" of the ESCB "shall be to maintain price stability"[17]. The ESCB will be composed of the ECB and the central banks of the Member States[18]. It shall be governed by the decision making bodies of the ECB[19] which include the Governors of the national central banks. The work of the ESCB is outlined below:

The basic tasks to be carried out through the ESCB shall be:

- to define and implement the monetary policy of the Community;

- to conduct foreign exchange operations consistent with the provisions of Article 109;

- to hold and manage the official foreign reserves of the Member States;

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[15]article 109 f (2 & 3)

[16]30 Years of Monetary Integration, ed Alfred Steinherr, p203

[17]article 105 (1)

[18]article 106 (1)

[19]article 106 (3)

- to promote the smooth operation of payment systems;
- to contribute to the smooth conduct of policies relating to the prudential supervision of credit institutions and the stability of the financial system.[20]

ii. European Central Bank [ECB]

The independent[21] ECB will be governed by a Governing Council composed of an Executive Board and the Governors of the national central banks. The Executive Council will consist of six members[22] drawn from "persons of standing and professional experience in monetary or banking matters...Their term of office shall be eight years and shall not be renewable".

The ECB has the exclusive right to authorize the issue of bank notes[23] within the Community, however, the ECB will share with the national central banks the actual role and process of issuing bank notes. Only notes issued by the ECB or the national central banks shall have the status of legal tender within the Community. Member States may issue coins subject to ECB approval of the volume[24].

Subject to certain provisos, the ECB must be consulted regarding "any proposed Community act within its field of competence" and "by national authorities regarding any draft legislative provision within its field of competence"[25].

D. Transitional Provisions

1. Stage Two

As was stated above "the second stage for achieving economic and monetary union shall begin on 1 January 1994"[26].

[20]article 105 (2 & 3)

[21]article 107

[22]article 109 (2)

[23]article 105 (a)

[24]article 105 (a) (2)

[25]article 108 (1)

[26]article 109 e (1)

From the start of Stage 2, the currency composition of the ECU basket shall not change. This measure will have a limited effect. Its greatest impact will be on ECU denominated deposits, loans and marketable securities. Stage 2 will also breathe life into the Community's new institutions, the EMI and the Monetary Committee (see above).

The date that transition to Stage 3 actually takes place will depend upon economic conditions, in particular upon the degree of economic convergence. Article 109j, as annotated by the provisions of a related Protocol, outlines criteria by which Member States will be judged.

- the achievement of a high degree of price stability, this will be apparent from a rate of inflation which is close to that of at most the three best performing Member States in terms of price stability;

- the sustainability of the government financial position; this will be apparent from having achieved budgetary positions without a government deficit that is excessive as determined in accordance with Article 104 B paragraph 6;

- the observance of the normal fluctuation margins provided for by the Exchange Rate Mechanism of the European Monetary System, for at least two years, without devaluing against any other Member State currency;

- the durability of convergence achieved by the Member State and of its participation in the Exchange Rate Mechanism of the European Monetary System being reflected in the long-term interest rate levels.

Currently Member States are submitting their own convergence plans to the Commission for comment. Virtually all countries have now done so, including Denmark, who, like the UK are also not formally committed to membership of stage three. The UK's convergence programme is substantially based upon the statement of government economic policy which appears in the Financial Statement & Budget Report (the *Redbook*) published now in November as revised by later forecasts. The convergence programmes are discussed by the Monetary Committee (see above) and in Ecofin Council meetings (including the UK delegation).

On the basis of the criteria above, and the success of Member States in realising their convergence programmes:

> "the Council meeting in the composition of Heads of State or of Government, shall acting by qualified majority, **not later than 31 December 1996**, decide:
>
> a) whether a majority of Member States fulfil the necessary conditions for the adoption of a single currency;

b) whether it is appropriate for the Community to enter the third stage."[27]

If the Council decides that it is an appropriate time, then it will set the date for the commencement of Stage 3.

If the date for the commencement of Stage 3 has **not** been set up by the end of 1997 "**the third stage will start on 1 January 1999**" [28]. In a previous version of the Treaty, the transition to stage three depended, in part, upon the number of countries that had passed the convergence test. It was then suggested that between six and eight countries would provide a `critical mass' of States able to form the nucleus of the new union. This idea has been retained at least for 1997, but has been dropped for the later date of 1999, and there is now no minimum number of eligible states requirement.

2. Stage Three

Stage 3 is full economic and monetary union, the terminus of a journey arguably begun in 1970.

The ECU will be irrevocably fixed according to the decision-making procedures as laid down within the framework of the European Monetary System only from the start of Stage 3. This is explained in more detail below:

> At the starting date of the third stage, the Council shall, acting with the unanimity of the Member States without a derogation, on a proposal from the Commission and after consulting the ECB, adopt the conversion rates at which their currencies will be irrevocably fixed and at which irrevocably fixed rate the ECU shall be substituted for these currencies, and the ECU will become a currency in its own right. This measure shall by itself not modify the external value of the ECU. The Council shall, acting according to the same procedure, also take the other measures necessary for the rapid introduction of the ECU as the single currency of those Member States.[29]

Obviously this procedure might mean that some countries which would otherwise want to join Stage 3 cannot do so. Such countries will be given derogations. These derogations will be examined "at least once every two years, or at the request of a Member State to see whether a Member State might be admitted".[30]

E. Protocol On Certain Provisions Relating To The United Kingdom

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[27]article 109 j (3)

[28]article 109 j (4)

[29]article 109 l (4)

[30]article 109 k (2)

The UK's 'opt out' is contained in a separate protocol to the Treaty and is shown in full in the appendix to this Paper, however, several key points should be made.

a. The UK cannot move to the third stage without a separate decision to do so by its government and Parliament.

b. The UK will have to decide upon entry before the Intergovernmental Conference in 1996, but if no date is set for the transition by then, the UK will have another chance to decide during 1997. If the UK decision is not to proceed to stage three, then the protocol provisions are activated. Thus until then, the UK has virtually the same 'status' with respect to the Treaty as any other Member State.

c. The UK has an 'opt in' rather than an 'opt out' of stage three.

There is a continuing interest in the extent to which the United Kingdom can 'opt out' of monetary union. This has always been a controversial point with positions being taken at both extremes. The Government's argument is a simple one: the opt-outs are legally binding and watertight and mean that we are bound by nothing. Other commentators, however, have argued that ratification of the Treaty binds the UK to accepting stage three and therefore, that our opt-out is worthless. A good description of this argument appeared in an article '**Monetary Policy After Maastricht**' written by Martin Howe a barrister specialising in Community law.

Howe starts by setting out the supremacy of Community law both as expressed in the Maastricht Treaty and in the Treaty of Rome. He points out that from stage one on, all signatories must run their economic policies according to the convergence rules. In other words, what are tests in stage two, are economic aims in stage one. Howe then tries to boil down whether or not there are any obligations arising out of ratification to a rather simple question. He says: "**The key question is whether or not the Treaty imposes an obligation to try** [to converge]". His point is that if it does, then our failure in the short term to rejoin the ERM and a continued disinclination to join EMU whenever it is set up, ie our reliance upon our opt- out, will be interpreted by the European courts as being in infringement of our Treaty obligations.

The counter argument to this is that it is just fine legal logic that takes what the framers of the Maastricht Treaty *envisaged* when it was being written, and then by turning these into irreversible commitments, brings the opt-out to an end on a legal basis. The hard legal facts are that the UK has some obvious, uncontrovertible and solid guarantees. For example, article 104 c (10) specifically excludes the right to bring actions against a Member State by virtue of Articles 169 & 170 of the Treaty of Rome, and hence effectively renders the European legal apparatus impotent with respect to the UK. Second, it seems rational to assume that since the Treaty was constructed upon a set of assumptions about economic circumstance that no longer apply, cessation of ERM normal bands etc (of which more below) then there may well be a whole range of circumstances which are simply not covered by it. Hence, where

there are gaps in the Treaty it is not safe to conclude that our opt-outs no longer apply.

IV The economic effects of monetary union and a single currency

A. Introduction

One of the difficulties in presenting the arguments for a single currency is in first defining the status quo: with what economic arrangement is one comparing EMU? At one extreme it could be with a loose, free trade area, with little or no formal economic or institutional linkages. Alternatively, one could compare it to an arrangement that stops just short of full EMU, ie a free trade, 'Single Market', fixed exchange rate federation, but with no trans-national authority or further surrender of economic sovereignty.

In its major work on the costs and benefits of moving to full EMU, the Commission in its study[31] stated that:

> "For the purpose of comparison with a future EMU...the point of departure is assumed to be a Community which has completed the Internal Market according to the 1992 programme, combined with the European Monetary System in which all Member States take part"[32]

Although this 'departure point' was an obvious one at the time, in that it broadly reflected the actual and expected development of the Community at that date (1990), other comparators could have been chosen and, with the experience of some countries after the crises of 1992 and 1993 in the ERM, different results might have been produced. For example it is doubtful whether the Commission would now conclude as it did then that:

> "About half the Community could proceed now to EMU with little difficulty, notably with their advanced degree of convergence in terms of inflation and cost trends. Three others...have some adjustments to make, The two remaining...could with political will, set their sights on participation in the full EMU, at the same time as the rest of the Community"[33]

Accepting though, that the Commission's approach began at a reasonable starting point, their

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[31]'One market, one money, European Economy No 44

[32]Source: op cit p 9

[33]Source: op cit p 12

analysis of the benefits of EMU contained four major headings, efficiency & growth, price stability, public finance, and adjustment to economic shocks. These are dealt with in turn.

1. Efficiency & Growth

Surprisingly, the most obvious (obvious at least to the general public) cost associated with different currencies and exchange rates actually score a lot less well in studies on the benefits of EMU than do most other factors. Articles regularly appear in newspapers describing the journey of a traveller starting off in one EU country with, say £100, who then changes it into francs in Paris, then Dmarks when they get to Munich etc, etc. By the time that they return to London, having visited all Member States, but not having spent any real money, they are left with about £50, the rest having gone in commission charges and differential exchange rates. Although the costs of changing money are considerable to individuals they are less onerous to business because of the higher volume of their transactions; many large companies have internal treasury operations anyway. Indeed, in a recent speech by the Governor of the Bank of England[34], the view was put that the costs to the individual had perhaps been overstated:

> "Anyone who travels throughout the European Union exchanging all his currency as he goes deserves to pay for the privilege - particularly in the age of the plastic card!"

Overstated or not, the Commission estimated that transaction costs can amount to at least 0.4% of GDP per year. Another benefit associated with the adoption of a single currency is improved transparency of prices. At its simplest, this says that it is easier to get value for money when buying abroad if you are familiar with the currency: tourists frequently pay too much for something in foreign shops simply because they cannot divide by the exchange rate accurately in their head. This effect also takes place at an industrial level and it is claimed that single currency pricing will complement the provisions of the Single Market and will increase competitive pressure and improve the economy. The biggest gains to come from EMU however, will be the reduction in exchange rate variability. Much of this is tied in with the expected benefits of lower inflation (see below), however, in its own right, it is clear that volatile exchange rates can have a dampening effect upon investment and growth. The Commission estimated that:

> "even a reduction in the risk premium of only 0.5 percentage points could raise income in the Community significantly, possibly up to 5-10% in the long run"[35]

2. Price Stability

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[34]Speech at the Association of French Bankers, 31/1/95

[35]Source: op cit p 63

The Commission repeat many of the well known arguments which conclude that price stability brings with it welfare gains. At its most basic, the argument is that if an economy functions by way of the price mechanism, any disruption of that mechanism will lead to sub-optimal economic outcomes. Inflation demands management time and effort to be expended coping with expected levels of future inflation; different groups in society are hit by unanticipated levels on inflation; pensioners see their savings reduced and workers their wages; and throughout the economy, agents are subjected to 'menu costs' as prices have to be regularly updated to reflect their underlying costs. From this position, the Commission assert that the institutions to be introduced under EMU, based as they are on the German model of central bank control, would eliminate inflation to the extent that it became a factor in the determination of economic agents' decision making processes. In the longer term the main factor promoting price stability will be the fact that the operation of monetary policy will be in the hands of the independent Central Bank (often now referred to as Eurofed), which will have as its constitutional "primary objective...to maintain price stability"[36]. It is to be expected that the combination of a body with this priority, working independently of countries that have already achieved a high degree of price stability separately (ie those countries that have already passed the inflation convergence criterion), should be able to deliver low inflation for the EMU collectively. Thus the benefits of monetary union are the benefits of low inflation. The better functioning price system might result in higher levels of investment since employers are better able to judge the future prospects for their firm in a low inflation environment. Within the EMU this is taken a step further. Since the inflation rates of separate members of the EMU cannot get too far out of line with one another, producers, when considering the site of new factories etc, can concentrate on 'real' variables, such as labour productivity, closeness to markets, appropriateness of infrastructure etc, rather than have to worry about monetary variables such as the wage inflation differential between say, German car workers and their Spanish counterparts. Thus the quality of investment, as well as its quantity might also rise in the EMU.

The main expected benefit to growth of the lower rate of inflation expected in the EMU is that the creation of the EMU will affect inflation expectations. Let us assume that wage bargainers in the EMU expect inflation to be lower inside it than outside, for the reasons given above, and they respond by lowering their own demands, and thus contribute to the achievement of even lower inflation levels. In the same speech the Governor accepted this view of how EMU might work:

> "With monetary union......persistent relative inflationary pressure in one part of the single currency region would then be punished by falling economic activity and rising unemployment. That realisation ought to make inflationary behaviour less likely - that is to say that the external discipline looked for from the ERM would be much more powerful [in the EMU]. The single monetary policy would anyway be beyond the reach of national governments, which would also logically have to accept constraints imposed by treaty on their

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[36]Article 105 Treaty on European Union , Cm 1934

> overall fiscal policies. And the private sector would be stuck with the inevitable consequences of inflationary price or wage behaviour."[37]

When, in this changed inflationary environment, governments - who remain in charge of fiscal policy - find out that inflation expectations are lower, they are then able to run the economy at higher levels of output, and hence employment, than they could have done previously without fear of accelerating inflation. Sometimes economists talk about a shift in the natural rate of unemployment (NRU) in such circumstances, where NRU is that rate of unemployment where the *rate* of inflation is stationary, ie it is non-accelerating. Clearly there are material gains if the economy can grow at 3% a year with inflation at 2%, than if it can only grow at 2½% with inflation at 2%. In a sense, this sort of argument has formed the basis of much of what the Governor of the Bank of England has been saying to the Chancellor during their monthly meetings to decide interest rates. The Governor has clearly been concerned for some time that the economy is growing too fast for inflation to remain low.

The Commission estimate that the direct benefits to the Community of lower inflation would be of the order of 0.3% of GDP[38]. This is in addition to the gains mentioned above with respect to higher growth of incomes.

3. Public Finance

Even within the generally pro-EMU account given by the Commission in its study, it is accepted that there are major implications for public finances in the move to EMU and that not all of these will be either beneficial or painless in the short run.

The two parts of the convergence criterion which deal with public finance, the borrowing and government debt criteria, were according to a Commission spokesman, deliberately set at levels below what was then the Community average. The reason for this was to reinforce the clear anti-inflationary goal of the Union, by setting a broadly anti-inflationary macro economic climate. The depth of the subsequent economic recession, which has affected all of the Member States, and the specific problems encountered by Germany following reunification, has turned a mildly deflationary aim into a severe test of fiscal contraction. The Commission's analysis was written before this became clear.

The main problem in this area, apart, that is, from meeting the convergence criteria, is that EMU would impose two contradictory pulls on public finances. First, in the absence of a nationally determined monetary policy, ie, no national interest rate or exchange rate, the need for discretionary fiscal policy to meet national needs increases. But, simultaneously, the need

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[37]Source: Paris 31/1/95

[38]Source: op cit p 87

for fiscal discipline increases inside a monetary union, when the national authorities are no longer able to monetise their debts and finance their borrowings by encouraging inflation: governments can no longer print money to pay for their debts.

> "Unsustainable budgetary positions in a Member State, ultimately leading to either default or debt monetization, would be a major threat to overall monetary stability. High and growing public debt ratios would lead to pressures on Euro-Fed *[now the ECB]* to soften its policy stance and more generally on the Community as a whole to provide financial relief."[39]

The Commission also point out that the benefit of lower average levels of inflation to be expected within the EMU will put a corresponding burden on governments. Inflation is an effective revenue raiser for governments. Revenue from taxes such as VAT automatically rise as domestic prices increase. The value of income tax allowances fall and, under a graduated tax system, as incomes rise more taxpayers come into the higher tax brackets and hence revenue increases. All this is accomplished without the government seemingly having to raise taxes. On the other side of the public finance equation, the value of government debt is eroded by inflation. According to the Commission, the revenue loss which would result from lower inflation may be in excess of 1% of GDP in some Member States[40].

4. Adjustment without an external exchange rate

The loss of an exchange rate as a policy instrument has important implications for macroeconomic policy. The recent experience of the UK shows the big impact that the devaluation of the domestic currency can have. A single currency would deprive Member States of the ability to alter their competitive position against what would probably be their main trading partners. With respect to countries outside of the Union, Member States will be in a semi-flexible position since the external value of the common currency will be determined by the ECB in consultation with the Council of Ministers, which will consider factors affecting all Member States.

Most of the academic discussion in this area has been conducted within the framework of consideration of shocks to the Union. How would the Union react to an economic shock such as an increase in commodity (oil) prices? In the literature, shocks are divided into two types, symmetric and asymmetrical shocks: shocks that affect all Member States equally, and shocks that affect them differently, either in scale or direction. If the shock is symmetrical, then there should be no need for exchange rate adjustments between Member States. Thus, it is the treatment of asymmetrical shocks which have occupied most attention. This is commonly

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[39] Source: op cit p122

[40]

explained with reference to how things work in another large monetary union: the United States of America.

Take two States, California and Texas. Assume that California earns all its money from making computers and Texas from drilling for oil. Both States pay Federal taxes, part of which are recycled back to their residents in the form of unemployment benefits, sickness benefits and the like. Imagine now that the price of oil doubles. Texan companies get richer, output increases and they employ more workers. Both corporate and individual tax payments increase. In California, computer companies have to pay more for their fuel, car drivers pay more too and buy less at local shops to economise. Both corporate and individual taxes fall, some people lose their jobs and start to claim benefits. At this point the role of the Federal government becomes obvious. Net budget contributions from Texas will rise and those from California will fall. In this way, it is estimated that about 40%[41] of the relative changes in income between the two States will be evened out.

Similar things could happen in a European monetary union, but, with the resources of the 'Eurofed' limited to 1.2% (rising to 1.27% after 1999) of GDP, and most of this being spent on agricultural support, the opportunity for any income redistribution around the monetary union is highly limited. Thus, a shock which perhaps benefitted the northern rim of Europe but adversely affected the Mediterranean area could not easily be evened out in the absence of relative exchange rate changes.

In the absence of an interventionist central body, responses to change will manifest themselves either in changes in real output and supply, or in changes to the price level, depending upon the degree to which factors of production are mobile within the Union. In a comparative study of the US and the EU[42] the authors find evidence that factor mobility is much lower in the EU than it is in the US. The implications of this for a proposed EMU are described below:

> "By adopting a single currency the EU is likely to reduce the short run flexibility of relative prices, making it more difficult and costly to adjust to underlying disturbances. Given the very steep estimated supply curve [ie, unresponsive] this will be particularly important in response to demand disturbances. Indeed, the exchange rate turmoil in 1992 and 1993 can be seen as an example of this, with the ERM of the EMS making it difficult for relative prices in the EU to respond sufficiently quickly to the rise in demand for west German products caused by German unification.
>
> In the longer term increasing integration of EU goods and factor markets should reduce the need for large movements in relative prices. Institutional

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[41]Source: Barry Eichengreen Economic Policy April 1990

[42]'Relative Prices & Economic Adjustment in the US and the EU: a Real Story About European Monetary Union, IMF Working Paper (Bayoumi & Thomas) 94/65

> changes, such as the recent completion of the single market in the EU are important in promoting this integration. Having said this, it does not appear likely that the EU will achieve anything like the levels of integration of US regions in the immediate future. In the shorter run, disruptive relative price adjustments can best be avoided by reducing the size of underlying disturbances in demand for regional products. Coordination of domestic aggregate demand policies across EU countries, such as the fiscal restraints incorporated in the Maastricht Treaty, can be seen as one method of moderating the problems likely to be associated with EMU."[43]

Similar sentiments were expressed by the Governor of the Bank of England when he said of the proposed monetary union:

> "But there could also be important disadvantages. [Some] people are less sanguine that monetary union will bring about the behavioural changes necessary to ensure the balanced economic development of the separate member countries.
>
> There is particular concern about both the conjunctural and the structural differences between the member countries that might exist at the time that the single currency came into effect....some of those risks are captured by the convergence criteria in the Maastricht Treaty, which seek to ensure that sustainable conjunctural convergence has been achieved before any move to a single currency. And it is why many people insist that the convergence criteria must be very strictly applied when the time comes. I agree with them.
>
> But the Maastricht convergence criteria do not address the deep-seated structural differences within Europe reflected in the generally high levels of unemployment - which - differ substantially from one country to another - and which seem unlikely to be substantially eroded by the present cyclical upturn. This problem, which is generally recognized as much the most urgent economic problem facing Europe, needs to be addressed through structural policies such as those being explored by the Commission and debated by the European Council. But it seems quite possible that a part of the answer to the widely differing levels of structural unemployment will need to be relative wage adjustment. It is hard to imagine that this could be brought about through a reduction in nominal wages in the high unemployment countries; and, without that, it is possible that there would be a need for exchange rate adjustment to help bring about a real wage adjustment."[44]

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[43]op cit p 17

[44]Source: Paris 31/1/95

The Commission's answer to the absence of an exchange rate policy tool is the familiar one that exchange rate movements only provide a temporary relief:

> "Since wages and prices are rigid in the short run, nominal exchange rate changes may affect real exchange rates for a while. This may dampen output fluctuations, but may increase inflation fluctuations. Over a longer period, nominal exchange rates tend at best to accommodate inflation differentials without having a lasting impact on real exchange rates.
>
> Real exchange rate changes are still possible through relative price movements within EMU, as the examples of existing federations and the experience of the EMS clearly show"[45]

The Commission argue, therefore, that if a country responds to an adverse shock by devaluing this will initially improve its position, but, as workers respond to higher import prices by demanding higher wages, domestic inflation will rise and domestic export prices will be back to their previous, uncompetitive levels, albeit with a higher level of domestic price inflation. This is the standard argument against all devaluations: they don't work in the long run, and even that the short run is very short indeed. Against this, however, if the costs of adjustment are to be met entirely by changes in the nominal cost of prices and wages, one has to accept that adjustment might well not be a painless process. This is particularly the case if one starts from a position of low inflation. Then, reductions in real wage costs cannot easily be effected by maintaining nominal values and allowing inflation to reduce their value. An historical illustration of the problems of the adjustment process with fixed exchange rates is the experience of the UK following the return to the gold standard in 1925.

The reasons why the country reverted back to the gold standard have been debated at length. Many commentators have stressed that the attraction was the prospect of 'sound money' which could be achieved through less painful means on 'gold' rather than outside of the system.

There has been a good deal of speculation on why unemployment remained so high after the return to gold. It is generally thought that the actual exchange rate chosen was about 10% too high. However, attention has also been paid to the rigidities that then existed in the labour market such as the high levels of unionisation of the workforce; a phenomena which was common to both Germany and the UK. It may have been due to these rigidities that most of the expected benefits of the return to gold standard between 1925 and 1931 were not realised. The expected automatic wage and price decreases consistent with the new exchange rate never materialised. What reductions there were, were offset by similar, and in some cases larger, reductions by competitors. Between 1925 and 1929 real earnings rose by 5.8%, while retail prices fell by 7%. The real effect of the overvalued exchange rate was felt in the traded sectors of the economy where a drop in the share of world trade contributed to a rise in unemployment of over 10% in 1929. The UK left the gold standard in 1931.

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[45]op cit p 137

The Commission, when they looked at the question of factor price adjustment specifically examined real wage rigidities. They argued[46] that the greater credibility of inflation control in the Union, and the controls on 'fiscal bail-outs' implied in Maastricht will increase labour market 'realism'. However, against this they noted that to the extent that there was a social dimension to the Union's policies, unrestrained income differentials were unlikely to be allowed to exist, a factor mentioned again in the Commission's White Paper on Competitiveness published in 1994. To the extent that considerations about minimum wages could create a wage norm, there will be a tendency towards wage rigidity in some of the extreme countries. Furthermore, the obvious alternative to direct real wage changes, regional mobility of labour, is accepted by the Commission as being "neither feasible, at least not across language barriers, nor perhaps desirable."[47]

Not specifically addressed by the Commission in their study was the criticism that under the new union a country surrenders economic sovereignty to an unelected, unrepresentative body, the ECB.

The argument about sovereignty is usually dealt with on one of two levels. First, is it the case that an institution set up by a Treaty agreed to by member states can really be described as being unrepresentative? In a sense it is like the judiciary in the UK. They are non-elected but their authority is accepted no less for that. Since many Member States already had independent or quasi independent central banks before Maastricht anyway, it is difficult to see that there is a constitutional problem.

Secondly, one should question how much economic sovereignty a nation actually has in today's world? Certainly it is clear that in a world where there are no controls on the movement of capital, any single government is unable to sustain a monetary policy that is at odds with what the markets think is credible. As was pointed in the 1960s by two IMF economists, Mundell and Flemming, it is clear that an economy can do two of three things:

- control international capital movements
- fix the exchange rate
- fix the interest rate

What it cannot do is control all three. Since the UK abolished the first in 1979, even outside of the ERM its choice was *between* the second and third factors. Once one fixes, for example, the market exchange rate, several other policy options fall into place too. Compatible with any given exchange rate there is probably a fairly narrow range, or combination, of policies that would gain market credibility. An 'independent' country could choose from a policy mix of loose fiscal policy and tight monetary policy (like the policy of

[46]op cit p 149

[47]op cit p 151

the US in some periods of the 1980s - although there was no obvious exchange rate target) or the other way around, perhaps like the UK in the last couple of years. Clearly, if monetary policy is fixed by the ECB, then the fiscal choices remaining for a country in the monetary union are more circumscribed too. This restriction is given a constitutional base too in the Maastricht Treaty, which limits government fiscal policy leading up until monetary union and prohibits central government 'bail outs' following from excessive borrowing by public authorities, broadly defined[48].

Clearly, the Commission's analysis is designed to portray EMU in a good light. Other, leading UK economists, including at least two of the six 'wise men' have severe doubts about the Commission's claims.

Tim Congdon[49] points out that the claims for lower inflation under EMU are as yet untested. How do we know that inflation will be lower. At the very least one might expect the central authorities to be less than perfect in their monetary management, at least in their early years. furthermore:

> "the French and Italian governments' enthusiasm for EMU arises partly from a wish to dilute German influence in the EMS, not to entrench it. The political will to control inflation is likely to be weaker in the EMU than it is at present."[50]

Congdon also finds that the benefits of transaction costs savings are by and large ascribable not to the existence of one currency but would arise anyway if financial markets were fundamentally deregulated and integrated, ie at the time that the Commission was writing, much of the cost of sending money abroad was the cost of sending it abroad, rather than actually changing it into another currency. Similarly he found the benefits arising from the improved flow of investment funds unconvincing. Since the UK was, at the same time, the largest recipient of inward investment and was not a member of the ERM, he concluded that factors other than exchange rate stability determined major investment decisions. In passing one could point out that these two factors appear to have reasserted themselves once again. He concluded by saying that:

> "In the transition to a single currency, there would be costs and no benefits...On the other hand, when the single currency is established, there would be mainly benefits. But these benefits tend to be exaggerated. Against these benefits some economists would emphasise the dangers of increased unemployment because of the loss of the devaluation option now available to European governments.

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[48]Cm 1934

[49]EMU *now?*, the leap to European money assessed, Centre for Policy Studies pamphlet

[50]op cit p 18

> Readers must make up their own minds whether this analysis justifies British participation in future moves to a single European Currency. But it is clear that the benefits do not overwhelm the costs. On economic grounds alone the decision is not clear-cut. The question must therefore be resolved by other considerations, particularly the political implications."

V. The Exchange Rate Mechanism (ERM) crisis and future prospects

A. The ERM Crises

This part of the Paper, looks at the ERM crisis of the early 1990s from the perspective of the transition to EMU. It does not try, other than in passing, to look at the reasons for the crisis.

The Maastricht Treaty was predicated upon the continuation of the economic and institutional trends established throughout the existence of the ERM since 1979. The Treaty assumed that the increasingly rigid ERM structure, revaluations had become rare since 1987, would be sustained and that the 'naturally' occurring convergence of economic indicators amongst ERM members would continue and thus would complement the increased economic discipline imposed by the Treaty as Stage 1 passed into Stage 2. In 1991 it was not fanciful to imagine that an exchange rate system of semi-rigid parity links, that had suffered no appreciable strain in their day to day operation could evolve within ten years into a fixed, one currency, system. Neither was it fanciful to imagine that the trend towards economic convergence on key monetary variables would do anything other than continue. It was within these parameters that the Treaty, and in particular the convergence criteria were established.

What might be called the rise and fall of the ERM is catalogued in the following table:

"We counted them in...

- Spain joins the ERM in June 1989
- UK joins the ERM in October 1990
- Norway announces link to the Ecu in October 1990
- Sweden announces link to the Ecu in April 1991
- Finland announces link to the Ecu in June 1991

- Portugal joins the ERM in April 1992
- Cyprus announces link to the Ecu in June 1992

...... and we counted them out

- Finland devalues the markka in November 1991
- Finland floats the markka on 8 September 1992
- Italy devalues the lira on 13 September 1992
- UK withdraws from the ERM on 16 September 1992
- Italy suspends intervention agreement in the ERM on 16 September 1992
- Spain devalues the peseta by 5% on 16 September 1992
- Sweden floats the krona on 19 November 1992
- Spain and Portugal devalue by 6% on 22 November 1992
- Norway floats the krone on 10 December 1992
- Ireland devalues the punt by 10% on 30 January 1993
- Spain devalues the peseta by 8% on 13 May 1993
- Portugal devalues the escudo by 6.5% on 13 May 1993
- All ERM currencies move to fluctuation bands of +/- 15% around unchanged central rates. Separate bilateral agreement between Germany and Netherlands to maintain +/- 2 ¼% bands on 2 August 1993"[51]

Interpretation of the 'facts' of the crisis, however, remains difficult, but important. Was the cause 'economic', in the sense that the member economies' were fundamentally unconverged, or was it caused by market speculation? The former would imply that there was a need for a lengthy period of convergence, the latter that the sooner Stage 3 comes the quicker. Perhaps not surprisingly, the Commission came to the conclusion most favourable from their point of view, that the cause was speculative attacks on currencies and, that by the logic of

[51]Source: P Temperton Ed, European Currency Crisis: What Chance Now For A Single Currency?

the market these attacks were strictly speaking illogical[52]: 1992 and 1993 crises were therefore simply ghastly mistakes. The IMF, however, took the contrary view, ie that there was an underlying economic cause of the crisis. Its analysis concentrated upon the fact that:

> "In the years preceding the crisis, limited adjustments of parities and a lack of full convergence of inflation resulted in significant real appreciations of the lira, the escudo, and the peseta, as well as of the Swedish krona..[also] the United Kingdom's central parity came to perceived by some in the market as ambitious...The bother important factor in generating pressures against official exchange rate parities was the clear market perception of serious inconsistencies between, on the one hand, the domestic requirements for monetary policies in a number of countries with lackluster [sic] economic activity: and, on the other hand, the external requirements, largely determined by German monetary policy."[53]

Despite the obvious difficulties of interpretation, there is still considerable support for the view that what happened in 1992 and 1993, makes the goal of a single currency more, and not less, desirable and, furthermore, enough remains of the pre-crisis system to carry on regardless. For example, although the ERM is no longer a narrow, rigid mechanism it still exists; currencies are under no discernable attack from the markets, and eventually the narrower bands can be reimposed. Secondly, the Maastricht Treaty has been ratified by all Member States and much of the necessary mass of secondary legislation required to flesh out the Treaty provisions has already passed the European Parliament. Lastly, the necessary institutions (the EMI) opened for business on time.

A less positive view was expressed by the Prime Minister, who said in an article in the Economist that:

> "I hope my fellow heads of government will resist the temptation to recite the mantra of full economic and monetary union as if nothing had changed. If they do recite it, it will have all the quaintness of a rain dance and about the same potency"[54]

Three facts that have been changed by the crisis. First, the psychological assumption that the ERM had fixed exchange rates for all time has gone. The market is now back to a view of the ERM as a being a looser conglomeration of currencies, the exchange rates of which can be altered. In particular, heads of government are now aware that they are less able to influence their domestic exchange rate through central bank intervention than they were when capital controls still existed. Secondly, and in some respects more fundamentally, the

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[52]Source: Commission Economic Papers Number 108, July 1994, p45

[53]IMF, world Economic Outlook, October 1993

[54]Economist 25/9/93

recession has blown apart the movement towards economic convergence as measured by the convergence criteria. Not only is convergence simply harder to achieve under recession conditions, but convergence as a process is no longer seen as an automatic tendency, but something that might have to be imposed from above, sometimes with painful political consequences. This is particularly true with respect to the conditions measuring fiscal policy. Lastly, a minor point that might also be made is that whereas to some extent the old, narrow ERM bands encouraged convergence, the new wider bands, since they are so wide as to impose virtually no discipline upon a country, allow a greater degree of economic autonomy.

The most obvious textural difficulty with the convergence criteria, in the light of the ERM crisis concerns the exchange rate criterion. The relevant protocol states:-

> "The criterion on participation in the Exchange Rate Mechanism of the European Monetary System referred to in the third indent of Article 109j(1) of this Treaty shall mean that a Member State has respected the normal fluctuation margins provided for by the Exchange Rate Mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against any other Member State's currency on its own initiative for the same period."

When it was drafted, all countries were in the ERM, except for Greece, and there had been no general realignment of currencies since 1987. The Treaty implicitly assumed that this would be the future pattern. In the light of the widening of the normal fluctuation band to ±15% in August 1993 the criterion became extremely difficult to interpret. At one extreme, one could argue that this is now the 'normal fluctuation margin' and that Member States need do nothing other than simply stay in the ERM to qualify. An alternative interpretation would be that the normal margins were the ±2¼% bands and hence most Member States, except currently the Netherlands and Germany failed on this criterion. In fact, according to reports from Agence Europe[55], the Ecofin meeting in December 1994 decided "during lunch" that:

> "The consensus by the Ministers on maintaining the wide band of fluctuation (which required no formal decision) implicitly means that this band will be considered to represent the "normal bands of fluctuation" established by the EMS ERM. These margins must be respected for at least two years before a country can enter into the final stage of EMU. This condition in the Maastricht Treaty, is as explicit as those pertaining to budget deficits or inflation, even though it is mentioned less often. It is obvious that none of the countries in the EMS will have difficulty complying with the 15% band. In practice, sheltered from attacks of speculation, these countries have been respecting the old band of 2.25% since August 1993, and Mr Alphandery emphasized that the exchange system would remain stable as long as the

[55] Agence Europe Nos 6371 & 6372 5/6/ December 1994

convergence criteria and the cohesion programmes are respected"

The crisis forced two countries out of the ERM (Italy and the United Kingdom) and several others were forced to devalued (Ireland, Portugal and Spain). France might be also considered to have failed on the grounds that the franc was subject to *severe tensions* during the period. Somewhat fortuitously, the two year period referred to in the protocol will 'end' sometime during 1995 (ie, two years after August 1993), in time for the 'examination' to be conducted in time before the 1996 Intergovernmental Conference takes place. The exact date for this is not known, however, according to the Treaty, the Council meeting in the composition of Heads Of State or of Government, shall meet **not later than 31 December 1996**. The only difficulties in meeting this criterion will, therefore, be for the countries that are currently outside of the ERM[56]. For these countries (Greece, Italy, the United Kingdom, Finland and Sweden) it would appear as though they will have to renegotiate (or negotiate in the case of Greece, Finland and Sweden) a central rate and rejoin the ERM before their two year 'probation' period can begin.

It might be the case that an alternative, retrospective, measure of currency stability could be introduced, but this would require the agreement of all Member States, some of whom might feel that countries which devalued, and reaped the benefits of that course, should not also be allowed to rejoin the ERM on such easy terms. If no such agreement were reached it would appear to be impossible for this group of countries to be included in the first members of EMU were that to happen in 1997. Italy has already indicated that this is the reality of their situation

It also remains to be seen whether Mr Alphandery's comments about the current stability of the ERM come true. The width of the rate bands has not prevented severe speculative pressure on the Spanish currency, also transmitted to the escudo. Internationally, problems with the Mexican peso and subsequently the US dollar, has promoted a 'flight to quality' around the world, of which the DMark has been the main European beneficiary.

What then is the future of the EMU plans, are they to be a re-enactment of the Werner plans, which were sunk by the devaluation of the dollar, or are they more robust?

B. Future Prospects: the political debate

As one might expect many different views have been expressed about the real implications for the EMU process. Three in particular have found favour. First, there is the commonly held view that the crisis means that the whole timetable is set back. That, essentially, a long

[56] Article 109 j (1) seems to indicate that membership of the ERM is requirement of successfully meeting the fourth criterion: "the durability of convergence achieved by the Member State *and* of its participation in the Exchange Rate Mechanism".

period of currency stability in a multi-currency, flexible arrangement is a prerequisite for a successful monetary union. Secondly, there is the view that there is no chance of union before there is a real convergence amongst the candidate economies, so do nothing and let the economies first recover from the recession. Lastly, and perhaps the most radical view, is that Stage 2 has been shown not to work so lets move to Stage 3 as soon as possible.

The first view has found support in both the UK Government and in Germany.

In a speech at the 'Conservative Way Forward' dinner, the Prime Minister said:

> "We cannot accept that sterling should be part of a single currency in '96 or '97. We don't believe anyone could sensibly go ahead then, but, if they do, we wouldn't be with them....No one knows what future economic circumstances will be. I will tell you my fear: unless economic conditions were right, a single currency would tear the European Union apart. And, by the right economic conditions, the government does not only mean the Maastricht criteria - they are a necessary but not a sufficient condition to justify a single currency....The plain fact is that the powerful forces of free markets will massively determine these events. And they cannot accurately be foreseen now."[57]

In Germany, there has been criticism of attempts by the Commission to tone down the demands of the convergence criteria, in order to allow more countries to qualify [a familiar French position]. An article in the Times noted that:

> "The German attitude is strongly influenced by its recent experience of monetary and political union with East Germany."[58]

And, in comments seemingly aimed at the UK, the Bundesbank President is reported as saying that:

> "Countries that do not have the willingness and the readiness to enter into a broadly conceived and politically constructive community of solidarity should exercise caution in entering a monetary union."

Comments by the President of the EMI also indicate that even if it was politically desirable, it is practically impossible to achieve EMU by 1997. Agence Europe reported the comments made by M Lamfalussy at an ECOFIN meeting (Brussels 21/12/94). They note that:

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[57]Source: Conservative Party Press Release 3/2/95

[58]The Times 22/11/94

> "the EMI has set itself a sort of countdown defining precisely what should be done to be able to present a blueprint by end 1996 for the European Central Bank. This would be the most difficult part of our mandate admitted Mr Lamfalussy, all the more as the EMI began work almost one year behind schedule owing to the delay in ratification of Maastricht....Mr Lamfalussy noted that the EMI had received a mandate to complete preparation of the third phase by the end of 1996 [but] bearing in mind convergence criteria and majorities set by the Treaty for entry into the third phase, he said he cannot rule out transition..in 1997 but that this did not seem "plausible" while 1999 appears more of a "serious possibility". He went on to add that we must think very seriously about the sequence of events between now and then and recalled that the Treaty is explicit on one point, that is, from day one of phase 3 currencies will be irrevocably interlocked, the Central Bank will come into function and there will be a single monetary policy;- it is also clear that, after a certain delay, there will be a single currency and that before expiry of this deadline, intermediate steps may be taken. Thus for example,...new notes may be used at the same time as the old notes for a certain time."

Answering questions about the relationship between those Member States inside any monetary union and those outside:

> "Mr Lamfalussy admitted that what is worrying is the prospect of a Monetary Union with a reduced number of countries and the behaviour of the countries on the outside. In his view, if the exchange rates of these countries [those outside] undergo major fluctuations, there will indeed be a danger. For this reason it would be necessary to "agree upon a sort of exchange mechanism type relationship, a sort of EMS" between countries which are in the Monetary Union and those which are outside."

The Governor of the Bank of England summed up his view of the appropriate pace towards EMU when he said:

> "In relation to fiscal and monetary policy in particular we [European Union Members] are agreed upon the importance of reducing underlying public borrowing, and upon the need to preserve both domestic price stability and reasonable stability in exchange rates. That will take us towards convergence in terms of the Maastricht criteria which are generally sensible guidelines for the conduct of national economic policies. It would be unfortunate nevertheless if, in moving in the right direction, some countries felt obliged to move at a pace that was driven by artificial deadlines rather than at a pace appropriate to their national circumstances. That dilemma does not arise for the UK - we are as likely as most to meet the Maastricht criteria within the next couple of years and it suits our national economic priorities that we

should."[59]

A member of the original Delors Committee, Miguel Boyer, supports the second option:

> "One cannot ask too much of an exchange rate system and it is an illusion to think that the discipline of fixed rates can automatically do national governments' work and impose sound, 'orthodox' behaviour on society...Let us maintain the strategy of the Maastricht Treaty in its most flexible interpretation, without returning to the narrow bands before attaining more significantly extensive convergence than has been achieved at present, and let us adhere to logic alone and not to arbitrary timetables."[60]

Support for the quick move to Stage 3 rest largely on the view that it was the Maastricht Treaty itself, and the timetable which it imposed, which largely caused the 1992 crisis in the first place. The argument was that countries whose exchange rates were fundamentally overvalued would have to devalue at some stage before 1995, the last date at which a country could devalue, and still have the qualifying two years currency stability ahead of EMU beginning in 1997, and still join with the founding group. Hence, countries had a one-off window of opportunity to get their exchange rates right before they were fixed for all time. Consequently, the markets began to look for likely devaluation candidates and acted accordingly. Clearly, the longer Stage 2 goes on for, the greater is the scope for uncertainty and speculation. A fast move to Stage 3 would catch out the markets and limit the impact of a recurrence of the difficulties experienced in 1992 and 1993.

According to the French Presidency of the Commission, the original timetable of Stage 3 by 1997 is still feasible. At an ECOFIN Council meeting on January 16th/17th 1995, Edmond Alphandery on behalf of the French Presidency urged Member Sates to work towards a speedy transition to Stage 3:

> "To this effect, Paris proposes proceeding with a review of public deficits in June [1995] in order to adapt this procedure to the timetable governing national procedures. Mr Alphandery also hoped to make the succession of different Community procedures more readable so that these exercises are understood-and thus accepted- by European public opinion. As for the third stage of EMU, he urged colleagues to begin (in the framework of the joint discussion with the governors of the central banks of the EMI) all technical

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[59]Source: Paris 31/1/95

[60]European Monetary Integration, ed A. Steinherr p87

> preparations to draw up a report on this for the European Council [at] Cannes."[61]

Within the framework of the Maastricht Treaty[62] during sometime in 1996, the Council have to decide,

- whether a majority of Member States (including the new Members) fulfil the necessary conditions for the adoption of a single currency; and

- whether it is appropriate for the Community to enter the third stage.

Therefore as a matter of arithmetic, EMU can only come about in 1997 if eight Member States can qualify. Since three countries have constitutional impediments to automatic entry (Germany, Denmark and the UK) and four others are not members of the ERM (Greece, Italy, Sweden and Finland) the prospects for a majority are slim.

The prospects for a 1999 start are much brighter, if only because there is no need for a majority of States to pass the criteria. What shape the Union takes will depend upon how the convergence criteria were interpreted. If more notice is taken of the actual reference levels of such things as debt and borrowing, rather than the more flexible trends, then a rather large group of countries could form the initial bloc. Stage 3, even by 1999 will, however, involve some very restrictive fiscal policy decisions being taken now, by several States whose determination to be in the first group will be severely tested.

C. Future Prospects: technical preparations

Technical preparations for the introduction of the single currency are, at the policy level, largely in the hands of the EMI (see above). At the more practical level, proposals have been commissioned from the Expert Group (the Group) drawn from the Community's banking industry as to the best way for Stage 3 to be introduced. The following comments summarise their interim report to the Commission published in January 1995.

The Group acknowledge that the instantaneous introduction of all the elements that will go to make up the single currency is most unlikely on the first day of Stage 3. They envisage that the exchange rates will be instantly and irrevocably fixed, central monetary control and commercial banking practices will convert 'overnight' (where overnight might possibly be a

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[61] Agence Europe

[62] Article 109 j (3)

long bank holiday weekend), but that the ECU currency, in the form of standardised notes and coins, would be introduced soon afterwards (where soon might be six months later). They have worked on the basis that the first day of Stage 3 will be 1st January 1999, although they do not rule out the possibility, on technical grounds, of an earlier transition.

Although it disqualifies itself from any practical role in the convergence exercise, the Group comments on what it sees as the important issues:

> "If economic policies are set according to the convergence criteria, this will provide economic agents with a sound basis on which to draw conclusions and on which to build expectations.
>
> Deviations from the spirit and the letter of the Treaty and questioning the convergence criteria, however, would have strong negative impacts. Markets would be deprived from having a reliable yardstick on which to assess progress towards Stage 3. For the public the future single currency would appear to be less strong than some of the present currencies and its introduction would become more difficult. In that field, like in others, uncertainty could be detrimental to the process."[63]

With regards to the detail of the changeover to Stage 3 the Group call attention to:

- The conversion of outstanding commercial contracts into the common currency denomination. The Commission are anxious to avoid a situation whereby contracts negotiated in national currency have to renegotiated in ECUs. They conclude that despite the positive action that can be taken at the centre, "a regulation at national law level seems, however, inevitable".

- Rounding, despite the inelegant mathematics involved, compared for example with the UK's switch to decimal currency, this is not seen as a problem by the Group.

- Legal tender. As a general rule they suggest (in accordance with Article 105a (1) of the Treaty) that ECU notes and coins should be legal tender throughout the single currency area, whereas notes and coins denominated in national currencies should be legal tender only in the country of issue. Thus in the case after Stage 3 when either the ECU and national currencies were circulating side by side, or when the ECU had replaced national currencies, national law would need to be altered to reflect the status

[63]Op cit p7

of the ECU.

- Commercial banking. At the start of Stage 3 all accounts, assets and liabilities would be denominated in ECUs. Payments in national currencies would be converted to ECUs and applied to the customer's account in ECUs. Statements could be printed in both national and ECU currencies. Withdrawals from hole-in-the-wall machines would be transacted in national currencies, but processed, electronically, in ECUs. The dual-currency requirement imposed upon the banks will be one of the most substantial direct costs of the entire changeover. An estimate by the ECU Banking Association put the cost to its members, mainly large banks, at about £175 million *each*. This dual period could last six months.

VI The State Of Convergence

A. Introduction

In its convergence assessment in the Annual Economic Report 1995, the Commission found both good and bad in the economic data.

> "Wage moderation, substantial productivity increases and a still relatively low degree of capacity utilisation have all helped to make additional progress towards convergence in the rates of inflation. The inflation situation in a majority of Member States is now relatively satisfactory. Unsatisfactory progress, however, has been made in reducing budget deficits. The strength of the recovery is offering an opportunity to step up efforts in this area. Exchange rates have been stable and progress has been made, towards convergence of long term interest rates. Provided that additional efforts are made, especially in the budgetary area, it is now realistic to expect that a majority of Member States could meet the EMU criteria by the deadlines set out in the Treaty. The strength of the recovery is also creating favourable conditions for a resumption of the catching up process of the less favoured countries and regions."[64]

This section of the Paper looks at which Member States might have met the criteria for convergence on the basis of the latest economic statistics available for 1994. Such an exercise should not be regarded as a definitive since the actual procedure for assessing convergence is likely to be more flexible than this 'snapshot' approach, with trends over time being examined as well as the latest available data. This was illustrated last year by the Commission's relatively generous interpretation of Ireland's debt to GDP ratio under the excessive budgets protocol. Given the introduction of 15% bands of fluctuation for most of

[64] EC Commission 1995 Annual Economic Report, p14

the currencies in the ERM and the accession of three new Member States, the application of the criteria on the observance of normal ERM fluctuation bands is particularly uncertain. Also, it should be noted that, in some cases, the precise economic series which will be used for the test on convergence have not yet been chosen.

For the purposes of this analysis suitable economic data published by the Commission or the Statistical Office of the European Communities (Eurostat) have been chosen as far as possible. The criteria in the protocol (as amplified in the protocol on excessive budget procedure) are set out in the following notes which also describe the data chosen for this exercise. The results of the analysis are summarised in the table on page 41.

B. The Convergence Test

1. Achievement of Price Stability.

The protocol states:-

> *The criterion on price stability referred to in the first indent of Article 109j(1) of this Treaty shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1½ percentage points that of, at most, the three best performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions.*

While the Treaty states that the comparison should be on the basis of consumer price indices adjusted for differences in national definitions, no such data exist at present. Eurostat has drawn up a Council regulation that prescribes that harmonised consumer price indices should be developed from Spring 1996. The methodology for constructing these price indices is currently under discussion. There is also some confusion as to whether the benchmark should be based on the third best country or on the average of the best three.

The data used here are the increases between 1993 and 1994 in the annual average consumer

price index of each Member State as published by Eurostat[65]. The three lowest inflation rates were for Finland (1.1%), France (1.8%) and Denmark (2.0%). The average of these three is 1.6% suggesting a threshold for this criteria of 3.1%. Four countries had inflation rates above this level; Greece (10.9%), Italy (4.0%), Portugal (5.2%) and Spain (4.7%). (Basing the threshold on the third best inflation rate would increase the threshold to 3.5% but would not enable any further countries to meet the criterion.)

2. Government Deficits and Borrowing

The protocol states:-

> *The criterion on the government budgetary position referred to in the second indent of Article 109j(1) of this Treaty shall mean that at the time of the examination the Member State is not the subject of a Council decision under Article 104c(6) of this Treaty that an excessive deficit exists.*

And the protocol on the excessive budget procedure states:-

> *The reference values referred to in Article 104c(2) of this Treaty are:*
>
> > *- 3% for the ratio of the planned or actual government deficit to gross domestic product at market prices;*
> >
> > *- 60% for the ratio of government debt to gross domestic product at market prices.*

As outturn data for 1994 are not available for all the Member States, forecasts published in European Commission documents[66] have been used to assess performance against both parts of this criterion.

2(a). Government deficit

The data to be used for assessing the budget deficit are general government net lending

[65] Source: Eurostat *Consumer Prices: Monthly* 1/95

[66] Source: European Economy Supplement `A' Nov/Dec 1994

(equivalent to the general government financial deficit) as defined in the European system of national accounts (ESA). All member states except Denmark, Ireland and Luxembourg had deficits in excess of 3% of GDP in 1994. Although deficits are expected to fall in the near future, the Commission forecast that nine of the fifteen Member States will still have deficits in excess of 3% of GDP in 1996.

2(b). Government debt

The Commission forecast that eight of the EC12 countries will exceed the 60% threshold in 1994; Belgium (140.1%), Denmark (78.0%), Greece (121.3%), Ireland (89.0%), Italy (123.7%), the Netherlands (78.8%), Portugal (70.4%) and Spain (63.5%). Data for the three new Member States are not yet available on the precise definition outlined in the Treaty. However, very similar data published by the OECD[67] suggest that Finland and Sweden would both fail this test and that debt in Austria would be close to the 60% threshold.

3. Observance of Normal ERM Fluctuation Margins.

The protocol states:-

> *The criterion on participation in the Exchange Rate Mechanism of the European Monetary System referred to in the third indent of Article 109j(1) of this Treaty shall mean that a Member State has respected the normal fluctuation margins provided for by the Exchange Rate Mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against any other Member State's currency on its own initiative for the same period.*

Following pressure on a number of ERM currencies, the fluctuation band was widened from ±2.5% to ±15% in August 1993. At an ECOFIN Council meeting on 6 December 1994 it was agreed that these wider bands would be treated as "normal" for the purposes of assessing performance against this criterion. In the table a country is shown as failing if it was not a member of the ERM at the end of 1994 (Austria, Greece, Finland, Italy, Sweden and the United Kingdom) or if it devalued during the course of 1993 or 1994 (Ireland, Portugal and Spain). Other countries such as France might be considered to have failed on the grounds that their currencies were subject to *severe tensions* during the period.

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[67] Source: OECD *Economic Outlook* December 1994 table A33

Of course, it is not possible for the three new members; Austria, Finland and Sweden to have met this test prior to their accession. However, the Austrian schilling has now joined the ERM and could, therefore, meet this criterion by early 1997.

4. Convergence of Interest Rates.

The protocol states:-

> *The criterion on the convergence of interest rates referred to in the fourth indent of Article 109j(1) of this Treaty shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best performing Member States in terms of price stability. Interest rates shall be measured on the basis of long term government bonds or comparable securities, taking into account differences in national definitions.*

The analysis in the table is based on the average yield in 1994 on long-term government bonds. Comparable data for Greece are not available and the three month treasury bill rate has been used instead. In cases where full-year data are not yet available averages for the first 10 months are used. Among those countries with the three lowest inflation rates; Denmark, Finland and France, the average long-term interest rate was (provisionally) 8.1% suggesting a threshold of 10.1%. On the basis of the available data, only Greece had interest rates above this level.

C. Conclusion

On the basis of these data, only Germany and Luxembourg among the EC12 would have satisfied all the criteria in 1994. France passed four of the five tests. Italy, Portugal and Spain passed only one. Greece failed all five. The remaining five countries - including the UK - passed three of the five tests.

It would have been impossible for Austria, Finland and Sweden to have met the test for EMU membership. The available data suggest that Austria passed three of the remaining four tests and Finland and Sweden two.

INDICATORS OF CONVERGENCE FOR 1994

Country	Inflation rate	Budget surplus(+)/ deficit(-) as % of GDP (a)	Public debt as % of GDP (b)	ERM member for two years to 31.12.94 without devaluation	Long-term interest rates (c)
{A} Data					
Austria	2.9%	-4.4%	58.0% (d)	No (f)	6.7%
Belgium	2.4%	-5.5%	140.1%	Yes	7.7%
Denmark	1.9%	-4.3%	78.0%	Yes	7.9%
Finland	1.1%	-4.7%	70.9% (d)	No (e)	8.8% (j)
France	1.6%	-5.6%	50.4%	Yes	7.5%
Germany (k)	3.0%	-2.9%	51.0%	Yes	6.7%
Greece	10.9%	-14.1%	121.3%	No (e)	17.9% (j)
Ireland	2.3%	-2.4%	89.0%	No (g)	8.2%
Italy	4.0% (i)	-9.6%	123.7%	No (e)	9.3% (j)
Luxembourg	2.2%	1.3%	9.2%	Yes	6.4% (j)
Netherlands	2.8%	-3.8%	78.8%	Yes	6.7%
Portugal	5.3% (i)	-6.2%	70.4%	No (h)	9.9% (j)
Spain	4.8%	-7.0%	63.5%	No (h)	9.7%
Sweden	2.2%	-11.7%	93.8% (d)	No (e)	9.5%
United Kingdom	2.5%	-6.3%	50.4%	No (e)	8.1%
{B} Performance					
Austria	Pass	Fail	Pass (d)	Fail (f)	Pass
Belgium	Pass	Fail	Fail	Pass	Pass
Denmark	Pass	Fail	Fail	Pass	Pass
Finland	Pass	Fail	Fail (d)	Fail (e)	Pass (j)
France	Pass	Fail	Pass	Pass	Pass
Germany (k)	Pass	Pass	Pass	Pass	Pass
Greece	Fail	Fail	Fail	Fail (e)	Fail (j)
Ireland	Pass	Pass	Fail	Fail (g)	Pass
Italy	Fail (i)	Fail	Fail	Fail (e)	Pass (j)
Luxembourg	Pass	Pass	Pass	Pass	Pass (j)
Netherlands	Pass	Fail	Fail	Pass	Pass
Portugal	Fail (i)	Fail	Fail	Fail (h)	Pass (j)
Spain	Fail	Fail	Fail	Fail (h)	Pass
Sweden	Pass	Fail	Fail (d)	Fail (e)	Pass
United Kingdom	Pass	Fail	Pass	Fail (e)	Pass

Notes: (a) EC Commission forecasts Autumn 1994.
(b) EC Commission forecasts Autumn 1994 except Austria, Finland & Sweden
(c) Yield on government bonds except Greece - three month treasury bills.
(d) OECD data on slightly different definitions.
(e) Not presently in ERM.
(f) Joined ERM in January 1995.
(g) Devalued in February 1993.
(h) Devalued May 1993.
(i) Average for the first 11 months of 1994.
(j) Average for first 10 months.
(k) Inflation figures relate to former West Germany only.

Sources: see text

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