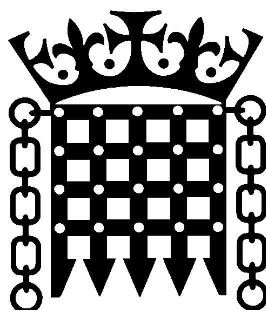
Economic & Monetary Union

Research Paper 96/110

29 November 1996



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 some of the recent documents published by the Commission concerning the preparations for EMU and the progress made by Member States as measured against the convergence criteria.

Timothy Edmonds
Economic Policy & Statistics Section

House of Commons Library

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Summary

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. 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.

The economic arguments for and against a single currency are complex. The substantial advantages of lower inflation, less volatile exchange rate movements etc are highly dependent upon the successful operation and management of an institution (the European Central Bank) that does not yet exist. The costs of EMU by contrast, are not only the, possibly exaggerated, future concerns regarding loss of sovereignty and lack of flexible adjustment, but are apparent now as candidate countries for EMU struggle to control their public finances.

The current plans for full economic and monetary union are derived from the experiences of the European Monetary System and the Exchange Rate Mechanism. This experience was of a loose grouping of currencies and economies moving towards an ever more rigid system of currency management together with convergent economic performance on such things as inflation and growth. In the fourteen years of the ERM's existence there were nineteen currency realignments. However, these occurred overwhelmingly in the early period of the ERM and there were no realignments at all between January 1987 and August 1992. The 'natural' progression and development of the system was interrupted by the crises of 1992 and 1993 which raised doubts about the feasibility of closer union. It was against this background that the Maastricht Treaty was drawn up.

The Maastricht Treaty 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 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. The most importance of these to this country is the UK's 'opt-out'.

Using the latest available data, and keeping as close as possible to the wording of the convergence criteria as stated in the Treaty and in later announcements, an estimate is made of the current state of convergence amongst Member States. It would appear as though only three countries, Luxembourg, Denmark and Ireland would qualify for EMU were it due to be established now.

CONTENTS

		Page
I.	**Introduction**	**1**
II.	**The moves towards monetary integration**	**1**
A.	The Werner Report	1
B.	The Snake	2
C.	The European Monetary System	3
III.	**'Maastricht' and the United Kingdom's 'opt-out'**	**10**
A.	Introduction	10
B.	Economic policy	10
C.	Institutional developments	13
D.	Transitional provisions	15
E.	Protocol on certain provisions relating to the UK: the 'opt out'	18
IV.	**The economic arguments for a monetary union**	**19**
A.	Introduction	19
B.	Efficiency & growth	20
C.	Price stability	21
D.	Public finance	23
E.	Adjustment without an exchange rate	24
V.	**Developments in the move towards EMU**	**29**
A.	Introduction	29
B.	Technical developments	30
C.	The political debate	42
VI.	**The state of convergence**	**45**
A.	Introduction	45
B.	The convergence test	46
C.	Conclusion	49

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. It reviews technical developments (both in Europe) in the move towards EMU . Lastly, it looks at the latest statistical data to see which countries currently qualify to join EMU.

II. The moves towards monetary integration

A. The Werner Report

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, but 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, although, some elements survived in the establishment of the 'Snake' in 1972.

B. The 'Snake'

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

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[1]HC Deb 23 October 1972 c791
[2]op cit c792

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.

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, 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. The Snake never operated as it had been intended. With the absence of France, the UK and Italy, Germany economically dominated the 'union' and consequently 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.

C. The European Monetary System

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.

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

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, 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."

Put briefly, the functioning of the EMS, and the ERM which was derived from it, could be characterised as being a rather long period of general success, punctuated by two periods of extreme crisis, one of which made it virtually toothless as a vehicle for exchange rate management.

The experience of the system in what was called Stage 1, 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. The system worked by having all currencies linked by a central rate to the ECU. Market currency rates were allowed to vary against their actual rate by up to ±2¼% (or 6% in some cases). As well as a rather complicated series of instruments and 'triggers' designed to correct exchange rate pressures when they emerged, members could also, in extremis, revalue their central rate. In the fourteen years of its existence there were nineteen realignments. However, these occurred overwhelmingly in the early period of the ERM and there were no realignments at all between January 1987 and August 1992. It was against this background that the Maastricht Treaty was drawn up. The Treaty assumed that the increasingly rigid ERM structure and the 'natural' convergence of economic indicators amongst ERM members would continue. This would complement the increased economic discipline imposed by the Treaty as Stage 1 passed into Stage 2. In 1991 it was not fanciful to conclude 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 conclude that the trend towards economic convergence on key monetary variables would do anything other than continue. Of course this was not the case and the ERM spectacularly exploded over the course of two Summers.

The rise and fall of the ERM is catalogued by one commentator 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 made between Germany and Netherlands to maintain ±2 ¼% bands on 2 August 1993"[4]

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

Interpretation of the 'facts' of the crisis 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 better. Perhaps not surprisingly, the Commission came to the conclusion most favourable to their point of view: the cause was speculative attacks on currencies and, that by the logic of the market these attacks were strictly speaking illogical[5]: the 1992 and 1993 crises were therefore simply terrible 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 other 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."[6]

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, rather than 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 and, eventually, the narrower bands can be reimposed. One of the countries forced out in 1992, Italy, has subsequently rejoined the ERM at a rate agreed to after long negotiations with other Member States and another, Austria, joined when it joined the EU. Furthermore, 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 institution (the EMI) opened for business on time.

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

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

[6]IMF, *World Economic Outlook,* October 1993

> "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"[7]

The ERM crisis and subsequent events have altered the perception of the path towards EMU. First, the psychological presumption that the ERM was already a fixed exchange rate regime in all but name, has gone. The market is now back to a view of the ERM as a being a looser association of currencies, the exchange rates of which can be altered, even within the broader bands as the events which lead up to the devaluation of the Peseta and Escudo in March 1995 showed. 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 possibly more fundamentally, the latest economic recession which affected much of Europe reversed much of the movement towards economic convergence as measured by the convergence criteria. Not only were some of the individual targets of the convergence criteria harder to achieve in a recession, 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 management of fiscal policy as events in France, Italy and Germany, have demonstrated.

Even before the recriminations which accompanied the years of ERM crisis the system was not without criticism. The France's ex-Finance Minister, Edouard Belladur, noted in a memorandum in January 1988 that:

> "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."[8]

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[7]Economist 25/9/93

[8]Quoted in Gros & Thygesen p313

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- Herr 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 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 following year.

A full description of the Delors report[9] has appeared in an earlier Library Paper[10] and it is only necessary to highlight a few relevant points here. The Report maintained that there was a fundamental and necessary link between the economic union, 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[11]. 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

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[9]The Report on Economic and Monetary Union in the European Community (12/4/89)
[10]Background Paper 233
[11]HC Deb 29 June 1989 c.1107

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 stages, 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 2 of this process, stage 1 having lasted from 1979 to 1994.

The Maastricht Treaty 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 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".[12] 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"[13]. 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

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[12]article 104 c (1)
[13]article 109 e (4)

the Member State involved. A Monetary Committee,[14] 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 and, then, public, recommendations about the failures of the Member State concerned. If a Member 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[15]. The ultimate sanction is set out in article 104c 11 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[16]. 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 73d 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

[14] article 109 c (1)
[15] article 104c (9)
[16] article 73 b

> 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.

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 2

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.[17]

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 2. 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;

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[17] article 109c (1)

- 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 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.[18]

The EMI began its operations in Basle but held its inaugural meeting in its permanent home in Frankfurt on the 11th January 1994[19]. The President of the EMI is Alexandre Lamfalussy, former Irish Central Bank Governor Maurice Doyle was nominated as Vice-President.

2. Stage 3

i. European System of Central Banks [ESCB]

The "primary objective" of the ESCB "shall be to maintain price stability"[20]. The ESCB will be composed of the ECB and the central banks of the Member States[21]. It shall be governed by the decision making bodies of the ECB[22] 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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[18] article 109 f (2 & 3)
[19] Alfred Steinherr ed, *30 Years of Monetary Integration,* p.203
[20] article 105 (1)
[21] article 106 (1)
[22] 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.[23]

ii. European Central Bank [ECB]

The independent[24] 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[25] 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[26] 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[27].

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"[28].

D. Transitional Provisions

1. Stage 2

The Treaty states that "the second stage for achieving economic and monetary union shall begin on 1 January 1994".[29]

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[23]article 105 (2 & 3)
[24]article 107
[25]article 109 (2)
[26]article 105 (a)
[27]article 105 (a) (2)
[28]article 108 (1)
[29]article 109e (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 also breathed life into the Community's new institutions, the EMI and the Monetary Committee (described above).

The date that transition to Stage 3 actually takes place, according to the Treaty, 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 the 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 104B 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.

Member States regularly submit their own convergence plans to the Commission for comment. All countries do so including Denmark who, like the UK, is not formally committed to membership of Stage 3. The UK's convergence programme is substantially based upon the statement of government economic policy which appears in the Financial Statement & Budget Report published 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."[30]

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**" [31]. In a previous version of the Treaty, the transition to Stage 3 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 dropped and there is now no minimum number of eligible states requirement. It should be noted that this section of the Treaty has been partly superseded by events. The Council Decision at the Cannes summit decided that 1997 would not be the starting date for Stage 3.

2. Stage 3

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.[32]

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".[33]

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[30]article 109j (3)
[31]article 109j (4)
[32]article 109 l (4)
[33]article 109 k (2)

E. Protocol On Certain Provisions Relating To The United Kingdom

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.

- The UK cannot move to the third stage without a separate decision to do so by its government and Parliament.
- The UK will have to decide whether to move formally to Stage 3 before the Heads of Government Council meeting that must take place before the end of 1996, but if no date is set for the transition by then, the UK will have another chance to decide during 1997. In fact, since it has already been decided (at Cannes) that Stage 3 will not begin in 1997, this is a purely technical decision. If the UK decides not to proceed to Stage 3, 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.
- The UK has an 'opt in' rather than an 'opt out' of Stage 3.

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 simple: the opt-outs are legally binding and watertight and mean that the UK is bound by nothing. Other commentators, however, have argued that ratification of the Treaty binds the UK to accepting Stage 3 and therefore that our opt-out is worthless. A good description of this argument appeared in a pamphlet *"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 ever since Stage 1, all signatories must run their economic policies according to the convergence rules. In other words, what are tests in Stage 2, are economic aims in Stage 1. 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 to take 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 104c (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 circumstances 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 arguments for monetary union

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[34] 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"[35]

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,

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[34]'European Commission, *"One market, one money"*, European Economy No 44

[35]Source: op cit p 9

> 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"[36]

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

B. Efficiency & Growth

Surprisingly, the most obvious (obvious at least to the general public) cost associated with different currencies and exchange rates actually scores less well in studies on the benefits of EMU than do some 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 speech by the Governor of the Bank of England[37], 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. In its review of EMU, the 'Panel of Independent Forecasters (the Wise Men)'[38] comment that for a large trading nation like the UK with well developed and competitive financial markets, the actual saving could be considerably smaller than this. If this were the main benefit of EMU, it would hardly be worthwhile.

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

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[36]Source: op cit p 12
[37]Speech at the Association of French Bankers, 31/1/95
[38]"Received Wisdom", Treasury Occasional Paper No 6, p 23

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"[39]

C. Price Stability

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 in coping with expected levels of future inflation; different groups in society are hit by unanticipated levels of inflation; pensioners see their savings reduced in value 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 as a factor in the determination of economic agents' decision making processes.

This assertion is said to be justified by the fact that the operation of monetary policy will be in the hands of the European Central Bank which will have as its constitution a "primary objective...to maintain price stability"[40]. 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

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[39]Source: op cit p 63

[40]Treaty on European Union, Cm 1934, article105

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 his speech in 1995, the Governor of the Bank Of England 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 overall fiscal policies. And the private sector would be stuck with the inevitable consequences of inflationary price or wage behaviour."[41]

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 describe this as a shift in the non-accelerating inflation rate of unemployment (NAIRU), where NAIRU is that rate of unemployment where the *rate* of inflation is stationary. 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 stuck at 2%.

The Commission estimate that the direct benefits to the Community of lower inflation would be of the order of 0.3% of GDP[42] but this is in addition to the much larger gains mentioned above with respect to higher growth of incomes.

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[41]Source: Paris 31 January 1995

[42]Source: op cit p 87

D. 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 commitment. 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 increases for discretionary fiscal policy to meet national needs. But, simultaneously, the need 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 [the ECB] to soften its policy stance and more generally on the Community as a whole to provide financial relief."[43]

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 taxpayers move into 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.

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[43]Source: op cit p122

E. Adjustment without an external exchange rate

The loss of an exchange rate as a policy instrument has important implications for macroeconomic policy. The experience of the UK shows the beneficial impact that a big 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 has occupied most attention. This is commonly 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%[44] 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 ECB 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.

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[44]Source: Barry Eichengreen, *Economic Policy*, April 1990

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[45] the authors found 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 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".[46]

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.
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> 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

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

[46] op cit p 17

> 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."[47]

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"[48]

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 prices. This is the standard argument against all devaluations: they don't work in the long run, and 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 level 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

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[47]Source: Paris 31/1/95

[48]op cit p 137

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 1 million in 1930. The UK left the gold standard in 1931.

The Commission, when they looked at the question of factor price adjustment specifically examined real wage rigidities. They argued[49] 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".[50]

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

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[49]op cit p 149

[50]op cit p 151

but their authority is accepted no less for that. Since many Member States already had independent or quasi independent central banks before Maastricht, 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 out as early as 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 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 until monetary union and prohibits central government 'bail outs' following from excessive borrowing by public authorities, broadly defined.[51]

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' advising the Chancellor of the Exchequer have severe doubts about the Commission's claims.

Tim Congdon[52] 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:

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[51]Cm 1934

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

> "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."[53]

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. At the time that the Commission was writing, much of the cost of sending money abroad was the actual transfer cost, rather than the cost of 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.
>
> 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. Developments in the move towards EMU

A. Introduction

Since the Summer of 1996 several documents have been published which have clarified some of the technicalities of the move towards Stage 3 a lot closer. These include:

- Treasury Committee: 'The prognosis for stage three of economic & monetary union', HC 283, 1995-96

[53] ibid p 18

- House of Lords Select Committee on the European Communities: 'An Emu of 'Ins' and 'outs'', HL Paper 86, 1995-96
- Bank of England: 'Practical Issues Arising from the introduction of the Euro'.
- Annual Report of the EMI: 'Progress towards convergence 1996'

Commission documents

- Com (96) 496: 'stability pact for ensuring budgetary discipline in stage 3 of EMU'
- Com (96) 498 'reinforced convergence procedures and a new exchange rate mechanism'
- Com (96) 499: 'the legal framework for the use of the euro'

The EMI report will be looked at later in connection with the position on convergence. The Commission's documents were the subject of debate both as to their treatment vis a vis the appropriate Parliamentary procedure for their scrutiny and as to what they entailed for the UK[54]. The section below looks solely at the technical content of these documents plus other technical and definitional matters that have been decided post-Treaty.

B. Technical developments

1. Progress with the convergence criteria and harmonisation of data.

The latest statistical information on progress by Member States against the convergence criteria is contained in a separate section of this Paper. This section will briefly summarise some of the policy and interpretational matters which have arisen during the course of the year.

i Price Stability

Some work has been carried out by the EMI to define more carefully what the Treaty criterion means and implies.

[54]See Chancellor's statement HC Debate 25 Nov 1996 c21

The Treaty is a little ambiguous when it states that the threshold inflation level is not more than *"1½ percentage points that of, at most, the three best performing Member States in terms of price stability"*. Work has also begun on the process of harmonising consumer price indices across Member States, since considerable differences currently exist in the way that different countries calculate 'inflation'. A Council Regulation[55], adopted in October 1995, established a framework for detailed future harmonisation work and a set of, interim indices of consumer prices (IICPs) were published in February 1996. These figures excluded the areas which were most controversial, ie those items which can be treated in a variety of ways. These include owner-occupier housing costs, insurance, health care and foreign holidays. Cutting out these items produces overall inflation rate results that are significantly different from national headline rates. Based on year on year figures for January 1996, the Commission calculated inflation rates compared to national rates are shown in the table on the following page.

Austria and Ireland are excluded from the table as their interim price indices have yet to be published. For several countries differences of about ±0.5% are apparent and quite clearly who passes and who fails the criteria is highly sensitive to the methodology that will eventually be chosen. The final indices (Harmonised Indices of Consumer Prices - HICPs) will be used from January 1997 and it is the HICPs that will be used from the convergence assessment in 1998.

Inflation estimates for EMU convergence
January 1996 yr on yr % change

	Commission calculated inflation rate	National inflation rate
Belgium	1.6	2.0
Denmark	1.8	1.7
Finland	0.8	0.5
France	2.0	2.0
Germany	1.4	1.6
Greece	8.1	8.4
Italy	5.7	5.4
Luxembourg	1.1	1.1
Netherlands	1.3	1.9
Portugal	2.3	2.5
Spain	3.9	3.9
Sweden	1.6	2.0
United Kingdom	3.2	2.9

Source: European Commission

The EMI have decided not, for the time being at least, to rule decisively one way or another on the meaning of the phrase *"at most, the three best performing Member States"*. Although they are inclined to start with a simple average of the three states with the lowest inflation rate, other options are being kept in mind. One reason for this given is that, conceivably, one state in recession could have a negative rate of inflation. Since this would be an untypical situation they would not want to be bound by the arithmetic result that its conclusion would throw up. Currently, however, this is an objection which is more imagined than actual.

[55]EC Reg 2494/95, 27 October 1995

ii Exchange Rate Stability

Ever since the ERM crisis in the summer of 1993, the exchange rate criterion has been most difficult to interpret. Opinions, even at the inner most depths of decision making, vary over the exact meaning of the criterion. It is possible to argue both that nothing fundamental has changed, or that there is no real criterion left worth talking about. For example, during his statement to the House on his return from the Madrid summit, the Prime Minister expressed the view that membership of the ERM was not a necessary condition for meeting this criterion. He said:

> "As I said in my statement, I do not propose that I take sterling back into a changed ERM in the next Parliament either. The right honourable Gentleman [Mr Peter Shore] concluded from that that we shall not meet the Maastricht criteria, but that is no longer the case, because the ERM that existed at the time of our membership no longer exists. If one were to apply those strict criteria, the reality would be that nobody would be able to enter a single currency. The other Maastricht criteria, of course, fully apply, while the ERM criteria for all of Europe disappear because...they were effectively to be part of the inner band of the ERM, which no longer exists."[56]

When he was subsequently pressed by Mr Shore (by way of a written question asking how and when the protocol was changed or altered) the Prime Minister replied that:

> "Article 3 of the protocol on the convergence criteria has been neither deleted or amended. It will be for the Council, meeting as Heads of State or Government in early 1998, to decide pursuant to the provisions of the treaty which member states fulfil the necessary conditions to move to stage 3 of economic and monetary union."[57]

This was an interesting exchange of views and touched upon some of the factors that need to be clarified now and which it is worth looking at in some detail.

When the protocol 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. It is worth recalling here that the exchange rate criterion is composed of both general and specific tests.

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[56] HC Deb 18th December 1995, c1227

[57] HC Deb 9th January 1996 c114w

The general test is that:

> *"a Member State has respected the normal fluctuation margins provided by the Exchange Rate Mechanism of the European Monetary System without severe tensions for at least the last two years before the examination."*

It is certainly the case that there remains some doubt about the meaning of the phrase "severe tensions" which is at the heart of the more general measure. The fluctuation margins were a convenient benchmark measure of severe tension when the Treaty was written but there are other possible measures and the approach of the EMI in its report is to present a range of measures of exchange rate stability.

There has also been some debate about the meaning of the word 'normal' fluctuation bands. Following the widening of the normal fluctuation band to ±15% in August 1993, the criterion became extremely difficult to interpret. At one extreme, it could be argued 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 is that the normal margins are the ±2¼% bands and hence most Member States, except currently the Netherlands and Germany fail on this criterion. According to reports from Agence Europe[58], at an Ecofin meeting in December 1994 it was decided 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 ±2¼% since August 1993, and Mr Alphandery emphasized that the exchange system would remain stable as long as the convergence criteria and the cohesion programmes are respected"

It should be noted that when, in August 1993, the decision was taken to widen the fluctuation bands, the central parity, to which the Treaty makes explicit reference was left unchanged.

Further clarification of the evolving official position came in the EMI's report[59] which noted that:

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

[59]Progress Towards Convergence, p33

> In 1991, when the Treaty was conceived, the "normal fluctuation margins were ±2.25% around bilateral central rates, whereas a ±6% band was a derogation from the rule. In August 1993 the decision was taken to widen the fluctuation margins to ±15%, and the interpretation of the criterion...became less straightforward. **On the other hand, the central parities remain unchanged and the requirements to be a member of the ERM remains an element of the Treaty.** The widening of the ERM bands created a new market environment...Account needs to be taken of the particular evolution of exchange rates in the EMS since 1993 in forming an ex post judgement

Summarising its assessment under the exchange rate criterion the EMI now conclude that:

> At this stage the EMI does not consider it appropriate to give a precise operational content to the measurement of exchange rate stability according to Article 109j of the Treaty, which could mechanically be applied also to forthcoming periods......Regarding the Treaty provision of ERM membership, there is a strong majority position within the EMI Council according to which the requirement of ERM membership applies. This is also reflected in the analysis [in the Annual Report]. A minority take the view that exchange rate stability based on sustainable underlying economic fundamentals is more important than the institutional setting within which stability is achieved.[60]

It is of course absolutely vital that this crucial issue of ERM membership be decided upon very quickly. As the Prime Minister pointed out in his written answer, judgement day on who will go forward to Stage 3 will be in March 1998 and the reference period will be the two preceding years. Non-membership of the ERM in March 1996 therefore, could, preclude a member state from joining the original group of EMU entrants even if it wanted to and thought it in its best interest so to do. The decision by the Italian government to rejoin the ERM on 24th November 1996 at a rate of 990 lira to the DMark, may be seen as supporting the view that membership is a requirement although there has been no official comment on this aspect.

iii Interest Rate Criterion

Since the interest rate threshold is calculated with reference to the countries with the best inflation performance, the basis of determination under that heading determines the choice of countries under this heading too. The choice of instruments to be measured has been harmonised. The interest rates to be measured are those applicable to bonds issued by central government with nearly ten years to maturity and the yields should be gross of tax.

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[60]EMI Annual Report 1996 p 41

If several bonds fall within this definition a simple average can be taken.

iv Government debt and borrowing criterion

There have been no major technical developments or changes to the interpretation of the Treaty in either of these areas.

Other developments

Although a good deal of preparatory work has already been undertaken by various working groups and committees connected with the EMI and the Commission, some of the most important details will not be known until barely a year before Stage 3 is meant to start. This includes the number and identity of those countries that will take part. Despite this, the European Council, meeting in Madrid in December 1995, approved a 'reference scenario' for the changeover to the single currency produced by the EMI, the Commission and the Ecofin Council. Hence, to all intents and purposes what follows is the blueprint for the next six years.

January 1st 1999 has been confirmed as the starting date for Stage 3. This means that if the Council is to determine which Member States are to go forward into monetary union in 1998, they will have to do this on the basis of economic data for 1997. Such data, may only just, be available for the Intergovernmental Conference (IGC) scheduled for Turin in March 1988. Thus there could be as little as nine months between the publication of data, the decision being taken and the start of Stage 3.

The name of the new currency will be the **euro** composed of 100 cents. According to the Presidency conclusions, "This name is meant as a full name, not as a prefix to be attached to the national currency names". Thus some previous expectations that the new currency would accommodate certain nationalistic sentiments and be called the euro-mark, euro-pound, etc, have been confounded. Since euros and ecus will be exchanged on a one for one basis[61] it would seem likely that there will be a need for lower denomination coins: one euro would be worth about 80 pence, five pence would be equivalent to something like one sixteenth of a euro and while retailers persist in selling goods priced £X.99, presumably there will remain a need for a single unit coin. According to the EMI, it has been decided that the highest value for a European coin will be 2 and that the notes would be in units of 5, 10, 20, 50, 100, 200 and 500 euros[62]. With such high value notes (500 euros = about £400) the technical

[61]See Madrid Presidency Conclusions, p 7

[62]EMI, 'Changeover to Single Currency, p 35

requirement for forge proof notes is very high indeed.

All the elements that are currently described in the Treaty with respect to the working of Stage 3 were confirmed in Madrid. What was new was the acceptance of the EMI's view that there should be a period of not more than three years from the start of Stage 3 before the new currency is introduced. Before then the ECB will open accounts for the settling of foreign exchange contracts in euros. Furthermore, it is expected that financial institutions will start to operate with dual accounting systems, euros and national currencies.

European-wide monetary policy, is to be effected through the Trans-European Automated Real Time Gross settlement Express Transfer (TARGET). TARGET is a payment system to allow high value euro payments to be settled in real time rather than at the end of the day in the EU. Real time gross settlement systems in Member States which participate in the single currency will be able to connect to TARGET. Real time gross settlement systems in Member States which do not participate in the single currency will be able to connect to TARGET to process the euro as a foreign currency. It is not yet apparent to what extent TARGET will be used in preference to other payments systems by banks in the UK, whether or not the UK joins EMU. ECB borrowings through the interbank market, will be denominated in euros. While national currencies exist foreign exchange markets will be merely arithmetic conversions between fellow EMU members and, with respect to third countries, rates will be quoted against the euro, rather than against the national currency.

Once the initial three year period is over the ECB will start (1st January 2002) to issue euro banknotes and coins (with national central banks) which will circulate in parallel with national currencies. The national central banks will then start to withdraw national currencies over a six month period, when the national currencies will cease to be legal tender. The period of six months was chosen for a variety of reasons. One was to reflect the minimum period of time that it would take to adapt the estimated 3.15 million vending machines and the 130,000 cash dispensers to the new currency.[63] Also the EMI wanted to strike a balance between a big bang approach, all changes happening straightaway, and a lengthy drawn out procedure that would not induce a sense of urgency. As it explains:

> "A final consideration relates to the learning process for the public at large. Although advance information campaigns will greatly assist in getting the public acquainted with the prospect of the new banknotes and coins, the challenge of the changeover in this area is not to be underestimated. It does not merely concern a new physical shape for a complete series of banknotes and coins; above all, it concerns a change in the unit of account. A six month period may be expected to offer a sufficiently long learning period. A very long period of co-circulation may have the opposite effect, in that it might lead people not to make an initial effort to get accustomed to the new unit of

[63]Ibid, EMI p 22

account."[64]

Thus to recap, Stage 3 starts in January 1999. The new currencies are introduced at the latest by January 2002 and national currencies disappear irrevocably by June 2002. At some point in 1998 the European Central Bank will have had to have been set up in order to be able to start work in January 1999.

With regards to the detail of the changeover to Stage 3 the following items have been identified as important issues by the Expert Group advising the Commission:

- 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 euros. 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 Expert Group. However, a representative of one of the big UK banks pointed out that unless conversion rates could be rounded to start with (eg euro1=DM 2, euro 1.5=£1 etc), all domestic banking computer transactions, currently done to just two decimal points, will need to be changed.

- Legal tender. As a general rule the Group suggests (in accordance with Article 105a (1) of the Treaty) that euro 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 after Stage 3 when either the euro and national currencies were circulating side by side, or when the euro had replaced national currencies, national law would need to be altered to reflect the status of the euro.

- Commercial banking. At the start of Stage 3 all accounts, assets and liabilities would be denominated in euros. Payments in national currencies would be converted to euros and applied to the customer's account in euros. Statements could be printed in both national and euros currencies. Withdrawals from hole-in-the-wall machines would be transacted in national currencies, but processed, electronically, in euros. The dual-currency requirement imposed upon the banks will be one of the most substantial

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[64] Op cit p23

> direct costs of the entire changeover. This dual period could last six months. Other costs to the banking system include such things as the training of staff and the printing of new cheque books etc, showing dual currencies. An estimate by the ECU Banking Association put the cost to its members, mainly large banks, at about £175 million *each*. Such costs would be reduced in the case of banks with no retail presence or if they were to use the opportunity to combine the changeover with updates to their computer systems that might be justified anyway (for example, changes consequent upon the arrival of the year 2000 for computer systems).

Further recent advances in preparation for EMU came in a series of Commission documents that were published in September 1996. To recap these were:

Com (96) 496: 'stability pact for ensuring budgetary discipline in stage 3 of EMU'

Com (96) 498 'reinforced convergence procedures and a new exchange rate mechanism'

Com (96) 499: 'the legal framework for the use of the euro'

The section below looks at the technical content of these documents and includes the Chancellor's comments made in his statement to the House[65].

i The stability pact

It has long been accepted that it was going to be necessary to set up some sort of mechanism to monitor, advise on and, if necessary, control, government indebtedness after EMU was established in order to maintain some sort of stability and equilibrium throughout the EMU. The intention has been to extend the current excessive deficits procedure

The basis for discussion was the conclusion of a Franco-German summit where various ideas were thrashed out and the general approach agreed between them. The first important point is that the continuing stability pact will be based upon what is currently in Article 103 and 104(c) of the Maastricht Treaty which is the basis for the surveillance procedure and the excessive deficits procedure[edp] in stage 2 of EMU; this way there is no need for negotiations on a new Treaty. The Commission propose that members of EMU should have a continuing duty to present budget plans to the council and the Commission who, by a system of qualified majority voting would decide whether an edp situation existed[66].

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[65] HC Deb 25th nov 1996 c21-24

[66] Countries that are 'out' will continue to have to present convergence plans.

According to reports in the press the German view, is that governments should aim for an average budget deficit of 1% thus allowing for larger deficits of up to 3% in downturns. The Commission suggest:

> Medium term budgetary objectives of close to balance or surplus. The 3% of GDP reference value for the deficit is therefore seen as an upper limit in *normal* circumstances.[67]

From what one can gather, much of the argument has been about the definition of '*normal* circumstances'. The obstacle in the path of an agreement on the pact appears to be the German insistence on a rigid definition of the economic circumstances when a country might be allowed to run a large budget deficit. According to the Financial Times[68] the Germans originally wanted a definition of a reduction in GDP of 2% over four consecutive quarters, but this has been rejected by other countries including the UK.

A major element of the stability pact yet to be finalised is the deterrence and punishment of members who exceed the guidelines. The document proposes a long procedure of vetting, advising and warning of governments that had persistent excessive deficits, culminating in fines of the order of 0.2% to 0.5% of GDP depending upon the size and persistence of the deficit. It does state, however, this procedure requires unanimity in Council before it can be adopted.

Some of the detail about this plan was discussed at a meeting in Brussels which was reported in the Financial Times. The account stated that:

> The Commission discussion highlighted the political tensions in the Emu project, notably over German demands for a 'Stability Pact' to guarantee fiscal discipline among countries participating inside the future single currency zone, and the extent to which national parliaments should enjoy some leeway in setting budgetary policy.
>
> The principle of a tough Stability Pact was endorsed at a meeting of EU finance ministers in Dublin last month which also agreed on the outline of a new exchange rate mechanism (ERM2) for countries not taking part in the future euro zone. In each case, the new rules helped to clarify ambiguities in the Maastricht treaty. The progress in Dublin impressed financial markets and strengthened the credibility of the Emu project; but now the hard bargaining has begun on the precise terms of the Stability Pact.
>
> The spirit of the Commission paper agreed in Brussels yesterday can best be summed up with its own slogan: prevention is better than cure. It falls into three separate areas:
>
> > * Prevention. Countries will be obliged to adopt 'stability programmes' containing budgetary goals which will be submitted to the European Commission and EU finance ministers within two

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[67] Com 96/496 p2

[68] 11th November 1996

months of the plans going to national parliaments. The medium term objective should be equilibrium or surplus but there should be a breathing space for annual cyclical variations, albeit without breaching the Maastricht treaty's target of 3 per cent of gross domestic product. At the same time, the Commission will operate an early warning system for identifying and correcting budgetary slippages.

* Deterrence. If a country gets into difficulty, it faces a threat of sanctions according to a clear timetable. Delinquent states would be given a 10-month warning if their budget deficits exceed 3 per cent of GDP. If a country fails to reduce its deficit, the decision-making Council of Ministers would order it to lodge a non-interest bearing deposit with the European Commission. If the excessive deficit remains after two years, it would be changed into a definitive fine paid to the EU budget. The sanctions - to be approved by a two-thirds majority of the votes of Emu participants - would be made up of a fixed element equivalent to 0.2 per cent of the country's GDP, plus the equivalent of one-tenth of a per cent of GDP for every 1 per cent over the 3 per cent maximum, up to a ceiling of 0.5 per cent.

* Flexibility. The Maastricht treaty does allow for leeway if governments breach the 3 per cent deficit limit in 'temporary and exceptional' circumstances. The Commission text says this should apply when resulting from 'an unusual event outside the control of the relevant member states and which has a major impact on the financial position of the general government, or when resulting from a severe economic downturn, in particular in the case of significant negative annual real growth'. [69]

According to the Commission, the procedure will work on the basis of publicly announced government decisions, with a period of at most four months being allowed to a government to reduce its declared excessive deficit.

In his statement to the House the Chancellor made the following points about the stability pact:

First, the opt out from EMU that the Prime Minister negotiated at Maastricht remains entirely unaffected.

Secondly, everything contained in the EU Stability Pact - including fines on "ins" - derives from and was foreshadowed in the Maastricht Treaty.

Thirdly, unless we join stage 3 of the EMU, we will retain, as now, control of domestic economic policy. We would still have our existing commitment to endeavour to avoid an excessive deficit but there is no question of any fines or other sanctions

[69] Financial Times 17 October 1996

being imposed on us for running an excessive deficit.

I know that some colleagues have raised the possibility that Recital 13 of the Draft Regulation strengthening surveillance could be used to impose policy obligations or sanctions that can be binding on Member States. This interpretation is incorrect. Article 103(5) can only be used to impose detailed rules as to procedure. Any recommendations that might be made under Article 103(4) are non-binding.

Finally, the Stability Pact makes good economic sense for the UK and for Europe as a means of making sure that EMU is soundly based, whether we are in or out of a single currency. If we are in, we need to ensure that no other member of EMU falls into excessive deficit or debt crisis which might tend to drive up interest rates. If we are out, we need the Euro-zone to be stable as the British economy is more successful when the economies of our major customers are successful. That is why I am negotiating so toughly in ECOFIN in British interests to get the details right. That is why Parliament must scrutinise properly what I am doing.

ii Legal framework for the use of the euro

Very briefly. Document 96/499 sets out the legal framework for the use of the euro. It is necessary to introduce this in order to permit the euro to be used in stage 3. Although in the planning stage of EMU, reference was made to the ECU as the common currency, it was never the case that the EMU ECU would be the same thing as the current ECU. The current ECU is composed of a basket of currencies and has no independent value. The Maastricht Treaty did not specify what the new common currency would be called and it was decided at the Madrid summit (see above) to call it the euro. The euro will have a value determined by the markets independent of those member states' currencies that remain after EMU (the outs). Obviously the currencies of the 'ins' will vanish. Hence, at a practical level the regulation makes provision for the exchange of values between the ECU and the euro at an exchange rate of one to one on the 1st January 1999; determines the degree of accuracy at which conversion rates will be fixed; provides for the continuity of contracts that span the creation of EMU, for example long term debt denominated in either the currencies of the 'ins', or in ECUs, where repayment is denominated in currencies that will no longer exist; and determines the time frame in which the procedure will take place. Only political agreement can be reached on this directive at present. The legal basis upon which it can be made law, Article 109 1 (4), will only be available after the decision is taken in 1998 as to who qualifies for EMU. However, it was thought unwise in the light of the consequences for financial markets of continuing the uncertainty about these matters, for a decision not to be reached in principle now at least.

iii Reinforced convergence procedures and a new exchange rate mechanism

The final document (96/498) deals with what happens to the 'outs' with respect to their convergence programmes after stage 3 begins and how the new ERM will operate. This will hardly apply to the UK since we are not in the ERM and our opt out exempts us from most of the convergence programmes. This is also the document with the least specific proposals in it and the one that is less fully complete. It is backed up by a discussion document from the European Monetary Institute. The Chancellor described the main features of the proposals in his statement to the House:

> The document gives opinions and advice on how, in the opinion of Central Bank Governors, a so-called mark 2 ERM for member states outside an EMU might operate in practice and how the monetary stability of the whole Union might be safeguarded in future. It makes it quite clear that membership and even co-operation on exchange rate matters will remain voluntary. The conclusions of the Florence Council, repeated by the EMI, stated of any ERM that 'Membership would be voluntary'. The EMI document also says 'Such closer co-operation would be concluded on a voluntary basis at the initiative of the individual non-Euro area Member State.' Article 109m of the Maastricht Treaty already states that exchange rate policy is a matter of common interest which is of course sensible as wild exchange rate fluctuations would be disruptive to trade in the single market. That provision goes back to the Treaty of Rome.

Under the proposals the new ERM (ERM2) non euro area currencies would have a central rate against the euro with a fluctuation band within which they could move. It is envisaged that this was 'expected to be relatively wide'[70] The central rates would be set in agreement between the ECB, the Ministers of EMU countries and the central bank governors of non-EMU participants. This arrangement has been described as a hub & spokes system, rather than the currency grid system of the current ERM in which all currencies are linked to each other. The potential to move to a more rigid system is implicit in the comments, however, it would not appear to be a starting point for ERM2. The legal basis for ERM2 would be an agreement between governments and between central banks, it would not be based in the Treaty.

C. The political debate

The Government's position on the single currency was outlined by the Prime Minister in a speech on the European Union in March 1995. Since it has been referred to by other ministers in later debates it is worth quoting at some length.

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[70]com doc 10526/96, letter from Director General of the EMI

"There is a large body of opinion across Europe that believes that a single currency could proceed around the turn of the century. Clearly, all 15 members of the European Union could not join...but a core group of countries could conceivably be ready [and that] could include the United Kingdom. If that core went ahead, it would radically change the nature of the whole European Union. At this stage, no one can safely predict what that would mean for those within the core and, equally important, what it would mean for the majority of members of the European Union, who would remain in the Union but beyond that core number of nations.

Mr. Lamont: Does my right hon. Friend agree that monetary union inevitably means political union?

The Prime Minister: No, I believe that it is possible to move forward to monetary union without necessarily moving forward to political union, but the qualification depends on the nature and style of monetary union and I will deal with that in a moment.

If the core went ahead, it would need to determine very carefully what that would mean for the rest of the European Union. To consider whether we should join that core at some future date means that we should consider the practical implications of joining it and, equally important, the practical implications of not joining and letting other nations go ahead without us. Let me consider what it would mean if...we were to go into a single currency at some future stage. If we were to join, we would need to lock exchange rates with other members; and possibly abolish the pound and the Scottish and Northern Ireland pounds. The relevant difficulties in terms of absorbing the Northern Irish pound and the Scottish pound and just having the pound sterling are absolutely trivial compared with the difficulties of replacing sterling with a single currency across 15 nation states, in addition to that, we should accept the possibility—perhaps even the likelihood, although no one can be certain about that—that a unified monetary policy would require a far greater alignment both of spending and of tax rates. If the House were to proceed with them, such changes would be the most sweeping changes in fiscal and monetary management that the House, with its history of control of supply, had ever considered and accepted in all its long and proud history.

The House knows, from the Maastricht negotiations and the opt-out that I negotiated there, that I am wary of a single currency for those economic reasons—wary of its economic impact and of the serious political and constitutional implications. However, if some of our partners do go ahead, there will be implications for this country in any event, albeit different ones. There is no way in which we can sit out that argument without its affecting us in one way or another.

If we stay out there are other serious implications to consider, and I shall spell them out to the House. No one at the moment can be entirely certain what the implications of staying out might be. We cannot know what the impact of a single currency might be on the pound sterling if the pound were outside it. We cannot know what the impact would be on the reputation and work of the City of London as the pre-eminent European centre if we were outside a single currency. We do not know what the impact would be on domestic or international investment in this country if we were outside a single currency, and we cannot know what the impact would be on employment.

At the moment [these] matters are necessarily unknown. They will become clearer as we move towards the point of decision; that is beyond doubt. However, as of this moment, the answer to those questions cannot possibly be known, except as a matter of hunch. It is for that reason that I believe that it is in our own national and economic interests to keep open the option of going into a single currency [Interruption.] and equally to keep open the option of deciding that it will not be in our national interest to go in.

I make no apologies now, nor will I in future, for deciding as an act of policy, in the interests of the country, that we should not make such a decision without the facts at our disposal to know the right answer. If a decision of great constitutional significance were to arise over a single currency

> or, for that matter—although I do not for a moment expect it to be the case—from the intergovernmental conference, a referendum could be necessary; it could be desirable, and I am prepared to keep that option open."[71]

Although the Prime Minister claimed in this statement that too much had been made of the differences between members of his own party, newspaper comment continues to point out the apparent differences in enthusiasm for and approach to Europe exemplified by, amongst others the Chancellor ('Clarke puts stress on EMU merits', Financial Times 30/9/95) and the Foreign Secretary ('Rifkind adopts hard line over single currency', The Times 27/12/95).

In the same debate on the 1st March, the Labour leader spelled out his Party's attitude in some detail. It can be simply summarised in the following direct response to a question:

> **Sir Peter Hordern**: If the Maastricht criteria were met in full, would the right hon. Gentleman sign up to a single currency?
>
> **Mr. Blair**: If the economic conditions are satisfied, the economic conditions that we have set out for real economic convergence; and if people can be persuaded on the necessary political consent -- those are the two conditions -- then I say yes. I also say that there is no constitutional barrier to joining.[72]

One development of note has been the announcement by the Labour Party that they will put the question of EMU membership to a referendum before entry. This position is similar to that held by the Government. this was outlined by the Prime Minister when he said:

> there are circumstances in which we think that it might be appropriate to have a referendum on..whether this country should decide to join a single currency, were one to go ahead in 1999...

and:

> we are examining at the moment what the appropriate circumstances might be.[73]

The attitude of the business community to the proposals remains mixed, with both sides able to find important industrialists to back their arguments. Perhaps, though, opinion may have swung in a positive direction. In what was claimed to be the biggest ever survey of business attitudes, the CBI found that:

- roughly one fifth of businesses were radically opposed to Maastricht;

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[71]HC Deb 1 March 1995 cc1065-1071
[72]HC Deb 1 March 1995 c1057
[73]HC Deb 12 March 1996 c780-781

- roughly the same number of businesses thought that the UK should be part of the leading group;

- 22% wanted not to join the leading group but thought that the UK should keep its options open and possibly join later; and

- 36% of businesses wanted the UK to keep its options open, including the option to be part of the leading group.[74]

As if to confound this survey, however, a survey of exporters, firms that one would think would benefit most from the single currency, returned a 54% 'no' vote to the question "do you wish to see a single currency in Europe?". In a follow up to this survey, most of those who voted 'no', did so because they thought that "they would lose their competitiveness"[75]. The TUC has become very strongly pro-Europe. In an interview, the TUC Secretary, said that:

> "The prospect of not being in EMU is very dispiriting for British industry...The TUC is the most pro-European of our major national institutions. We want to see positive signs that we will be at the core of any EMU... Our role as reluctant participant in the EU has not served the country well"[76]

VI The State Of Convergence

A. Introduction

In its convergence assessment in the Progress towards Convergence 1996, the EMI found both good and bad in the economic data.

> the current environment of low cost and price pressures can be seen as favourable. Most Member States are enjoying relatively low inflation and many have achieved price stability....[also] a higher degree of exchange rate stability and a reduction in long term interest rate differentials. By contrast progress in fiscal consolidation has generally been slow. Most countries have not yet achieved a situation which, in a broader view, might be judged as sustainable in the medium term. With regard to the issue of sustainability it is emphasised that the improvement of the deficit by measures with a one off effect does not ensure sustainable consolidation and great attention will have

[74]Reported Independent 7 Nov 1995
[75]NCM Credit Insurance Survey, October 1995
[76]Financial Times 27 December 1995

> to be paid to the substance and not only to the accounting methods in measuring both deficits and debts.[77]

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 1996. 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 is illustrated by the Commission's relatively generous interpretation of Ireland's debt to GDP ratio under the excessive budgets protocol. Furthermore, the introduction of 15% bands of fluctuation for most of 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.

For the purposes of this analysis the latest data as published by the EMI have been chosen. 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 50.

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.*

Harmonised data, albeit in an interim form, has only just been made available and the table now incorporates this. The benchmark is based on the average of the best three. The Commission seem to suggest[78] that the preferred measure will be the average of the annual

[77] op cit p iii

[78] European Economy Supp A January 1996

year on year average rate of inflation in the three Member States with lowest inflation.

The data used here are the yearly increases between September 1995 and October 1996 in the annual average consumer price index of each Member State. Note, this is not the methodology which will actually be used in determining who will qualify, however, it does give a better indication of what current trends are. The three lowest inflation rates were for Finland (0.9%), Netherlands (1.2%) and Germany (1.3%). The average of these three is 1.1% suggesting a threshold for this criteria of 2.6%. Five countries had inflation rates above this level; Greece (8.4%), Italy (4.7%), Portugal (3.0%), the UK (3.0%) and Spain (3.8%). Therefore, ten countries meet this criteria.

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.*

The data for 1996 is based upon the Autumn forecast published by the Commission for the 1996 financial year and has 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 (equivalent to the general government financial deficit) as defined in the European system of

national accounts (ESA). All member states except Denmark, Ireland, the Netherlands and Luxembourg have forecast deficits in excess of 3% of GDP for 1996.

2(b). Government debt

The Commission forecast that twelve of the EC15 countries will exceed the 60% threshold in 1996; Austria (71.7%), Belgium (130.6%), Denmark (70.2%), Finland (61.3%), Greece (110.6%), Ireland (74.7%), Italy (123.4%), the Netherlands (78.7%), Portugal (71.1%), Germany (60.8%), Sweden (78.1%) and Spain (67.8%). However, both Ireland and Denmark have a derogation from the excessive deficit judgement and are treated as though they were under the reference level.

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.*

The difficulties in interpreting this criterion have been dealt with extensively earlier in this Paper. For the purposes of this exercise, the test has been whether the Member State has been in the ERM for at least two years without devaluing. Eight Member States passed this criterion, a substantial increase on last year, when the 1993 devaluations of countries such as Spain and Portugal still 'counted'. Italy rejoined the ERM following negotiations with other Member States' central banks on the 24th November 1996.

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 is a member of 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 averages of long-term interest rates in the year to September 1996 using the harmonised data collected by the Commission. Among those countries with the three lowest inflation rates (Finland, Netherlands and Germany) the average long-term interest rate was 6.7% suggesting a threshold of 8.7%. On this basis Greece, Italy, Portugal, and Spain had interest rates above this level.

C. Conclusion

On the basis of these data, only Denmark, Ireland and Luxembourg currently satisfy all the criteria. If these countries provide the 'core' for 1999, France and the Netherlands are on the outskirts, passing four of the five tests. Belgium and Germany passed three each, Austria, Finland, Sweden and the United Kingdom two each, Spain and Portugal one each. Greece and Italy are on the periphery having failed all five.

It would have been impossible for Austria, Finland and Sweden to have met the test for EMU membership. Since Austria and Italy are now both members of the ERM it would seem as though Austria might reasonably be along side Belgium and Italy along side Spain & Portugal in terms of their status.

Maastrich convergence criteria

{A} Latest data

	Inflation Oct-95 - Sept 96	Interest rates period average Oct-95 - Sept 96	General government gross debt % GDP 1996/97 forecast	ERM member for two years as at 1.11.96	General government deficit % GDP 1996/97 forecast
Belgium	1.6	6.7	130.6	yes	-3.3
Denmark	2.2	7.4	70.2	yes	-1.4
Germany, Federal Republic	1.3	6.3	60.8	yes	-4.0
Greece	8.4	15.1	110.6	no (a)	-7.9
Spain	3.8	9.5	67.8	yes	-4.4
France	2.1	6.6	56.4	yes	-4.0
Ireland	2.1	7.5	74.7	yes	-1.6
Italy	4.7	10.3	123.4	no (c)	-6.6
Luxembourg	1.3	7.0	7.8	yes	0.9
Netherlands	1.2	6.3	78.7	yes	-2.6
Austria	1.7	6.5	71.7	no (b)	-4.3
Portugal	3.0	9.4	71.1	yes	-4.0
Finland	0.9	7.4	61.3	no (a)	-3.3
Sweden	1.6	8.5	78.1	no (a)	-3.9
United Kingdom	3.0	8.0	56.3	no (a)	-4.6
EU average	*2.7*	*7.7*	*74*	na	*-4.4*
Reference value	2.6	8.7	60.0	na	-3.0

{B} Performance

	Inflation	Interest rates	General government gross debt	ERM member	General government deficit
Belgium	Pass	Pass	Fail	Pass	Fail
Denmark	Pass	Pass	Fail	Pass	Pass
Germany, Federal Republic	Pass	Pass	Fail	Pass	Fail
Greece	Fail	Fail	Fail	Fail	Fail
Spain	Fail	Fail	Fail	Pass	Fail
France	Pass	Pass	Pass	Pass	Fail
Ireland	Fail	Pass	Fail	Pass	Pass
Italy	Fail	Fail	Fail	Fail	Fail
Luxembourg	Pass	Pass	Pass	Pass	Pass
Netherlands	Pass	Pass	Fail	Pass	Pass
Austria	Pass	Pass	Fail	Fail	Fail
Portugal	Fail	Fail	Fail	Pass	Fail
Finland	Pass	Pass	Fail	Fail	Fail
Sweden	Pass	Pass	Fail	Fail	Fail
United Kingdom	Fail	Pass	Pass	Fail	Fail

Notes: (a) Not presently in ERM.
(b) Joined ERM in January 1995.
(c) re-joined ERM November 1996
(d) Although arithmetically Ireland & Denmark fail on this criterion, the Council decided to award a derogation to the excessive deficits procedure on account of the progress made by both towards the reference level.

Source: European Monetary Institute, November 1996

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[79]