Economic & Monetary Union

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This Paper updates previous Library Papers that dealt with the economic and monetary union provisions of the Maastricht Treaty. It describes the political and economic history of previous European attempts at closer monetary integration. It summarises 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.

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Summary

For more than twenty years European politicians and civil servants 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, while 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 and less volatile exchange rate movements are highly dependent upon the success of an institution (the European Central Bank) that does not yet exist. The costs of EMU, by contrast, are not only the possibly exaggerated concerns for the future over loss of sovereignty and lack of flexibility but are already 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 experience 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 in such areas 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 were 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 outlined the future path towards full economic union, and tried to avoid the experience of German reunification, which showed how painful immediate union could be despite 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 adequate institutional framework 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. For the United Kingdom the most important of these was the '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. The data suggest that only three countries - Luxembourg, Denmark and Ireland - would qualify for EMU if it were to be established now.

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I. Introduction

For more than twenty years European politicians and civil servants 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, while yet others have seen it as a way to import an economic model that has worked successfully in the major economy of Europe: Germany. During this period, enthusiasm has fluctuated, priorities have varied and doubts have crept in about some of the benefits. Furthermore, politicians in several countries have been forced to realise first, that 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 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 might currently qualify to join EMU.

II. The moves towards monetary integration

A. The Werner Report

Many accounts of the attempts by Member States to move closer together and towards some kind of monetary union 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 re-establish 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'.

Compared with the Maastricht Treaty, the Werner plan paid little attention to the institutional requirements of the union. It also paid less attention to the subject of economic convergence,

but more 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, began. The process received political endorsement from the newly joined 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. The Werner Plan received a mortal blow only five months after it received political affirmation, when the Bretton Woods system, which then underpinned the world currency markets, collapsed following the devaluation of the US dollar in August 1971. This effectively precluded the plan's chances of surviving, 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 of Commons in a statement by the then Prime Minister, Mr Heath, 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.[1]

On monetary union, the Prime Minister said:

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

From this declaration a system which came to be called the 'Snake within the (dollar) tunnel' emerged. Under the monetary regime which superseded Bretton Woods, the Smithsonian agreement in 1971, European currencies could move bilaterally against each other by up to 9%. In Europe, however, it was felt that 9% was too big a margin to accommodate the

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

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 currency rates 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 the system:

> 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 became apparent from the episode 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 was encouraged by several events in the late 1970s. First, there was 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 ways in which to provide economic support for the country. Thirdly, there was a desire in Germany to decouple from the increasingly unstable US dollar. A collapse in the value of the dollar worldwide could be expected to result in an increase in the attractiveness of the DMark and would encourage the currency to appreciate

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

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 size alone would be very important to any closer European arrangement.

Simultaneous to these developments was the accession to the Commission Presidency of Roy (now Lord) Jenkins. In a series of speeches during 1977, he re-launched the idea of monetary union and floated the idea of greater fiscal powers for the Commission. When the ideas were presented at ECOFIN and Council meetings at the end of 1977, the idea of fiscal federalism was rejected, but the bold plans for monetary union remained on the table. These 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 developed more fully 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, may be described as a fairly lengthy period of general success but punctuated by two periods of extreme crisis, one of which crippled it 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 regime 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 EMS 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, member states 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 none 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 among 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 unreasonable to assume that an exchange rate system of semi-rigid parity links which had suffered no significant strain in its day to day operation, could evolve within ten years into a fixed, one currency, system. Neither was it unreasonable to assume that the trend towards economic convergence on key monetary variables would do anything other than continue. In practice both assumptions were mistaken and the ERM collapsed spectacularly over the course of the next two Summers.

Interpretation of the 'facts' of the crisis remains difficult, but important. Was the cause 'economic', in the sense that the member economies had fundamentally failed to converge, or was it market speculation? The former would imply that there was a need for a lengthy period of convergence, the latter that the sooner Stage 3 came the better. Perhaps not surprisingly, the Commission concluded (favourably for their point of view) the cause was speculative attacks on currencies and by the logic of the market these attacks were strictly

speaking illogical:[4] the 1992 and 1993 crises were therefore simply terrible mistakes.

The IMF, however, took the contrary view 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.[5]

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, subsequently rejoined the ERM in November 1996 at a rate agreed after long negotiations with other Member States. The number of Member States participating in the ERM has also recently increased, Austria, joined on entry to the EU and Finland joined in October 1996. Furthermore, the Maastricht Treaty has been ratified by all Member States and much of the necessary secondary legislation required to implement 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:

> 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.[6]

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[4]Source: Commission Economic Papers Number 108, July 1994, p45
[5]IMF, *World Economic Outlook,* October 1993
[6]Economist 25 September 1993

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 now sees the ERM as a looser association of currencies, the exchange rates of which can be altered, even within the broader bands as the events which led up to the devaluation of the peseta and escudo in March 1995 showed. 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. Furthermore, the latest economic recession which affected Europe reversed much of the movement towards economic convergence as measured by the Maastricht 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. Conceivably it would have to be imposed from above, possibly 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.

The ERM system had its critics even before the recriminations which accompanied the years of ERM crisis. France's ex-Finance Minister, Edouard Balladur, 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.[7]

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 [through an undervalued DMark] so as to remove growth potential from other countries". The German Finance Minister, Herr Genscher, responded with his own memorandum, '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

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[7] Quoted in Gros & Thygesen, op cit p313

of economic policies of Member States without which monetary union could not exist. Events proceeded quickly and the European Council meeting at Hanover in June 1988 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[8] has appeared in an earlier Library Paper[9] 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: relative devaluation of the currency was an abuse of the free trade area. This linkage was very controversial and successive UK governments have maintained that common standards and the free movement of people and capital were not compromised by the existence of national currencies. 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, it argued that 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.[10] On the basis of the Report, the Commission staff prepared proposals for EMU which eventually became the Maastricht Treaty.

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[8]The Report on Economic and Monetary Union in the European Community, 12 April 1989
[9]Background Paper 233, 22 July 1989
[10]HC Deb 29 June 1989 c.1107

III. The 'Maastricht' treaty[11]

A. Introduction

For the movement to full EMU to succeed with the minimum of economic and political 'pain', the Community intended to move in measured steps or stages, each one building upon and consequent upon the successful completion of the previous phase. Since 1 January 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 showed 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 important of these to this country is the UK's 'opt-out'.

In the following section 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 of "close co-ordination of Member States' economic policies" 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:

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[11]Treaty on European Union, 7th February 1992, Cm1934

> 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%;

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

- whether the ratio of government debt to gross domestic product exceeds 60%, and if so, whether the ratio is not sufficiently diminishing and not approaching 60% at a satisfactory pace.

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

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

If a Member State looks to be in danger of failing to meet the criteria there then follows a long drawn-out procedure of ever-increasing severity. The Commission prepares a report on the Member State involved. A Monetary Committee,[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 which 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 more serious sanctions are set out in article 104c 11:

> 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;

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

- 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] Those countries which were entitled to have capital controls up to 31 December 1993 might 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.

Article 73(d) would, however, enable Member States:

- to apply the relevant provisions of their tax law which distinguish between tax-payers who are not in the same situation with regard to the place of residence or the place where their capital is invested;

- to take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation and the prudential supervision of financial institutions, or to lay down procedures for the declaration of capital movements for purposes of administrative or statistical information, or to take measures which are justified on grounds of public policy or public security.

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

[16] article 73 b

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 Member States. Its membership includes two representatives, normally one central bank official and one finance ministry official, from each Member 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;

- 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

[17] article 109c (1)

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 at its permanent home in Frankfurt on the 11th January 1994. The President of the EMI is Alexandre Lamfalussy who was previously a General Manager at the Bank for International Settlements in Basle. The 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".[19] The ESCB will be composed of the ECB and the central banks of the Member States.[20] It shall be governed by the decision making bodies of the ECB[21] 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;

- to promote the smooth operation of payment systems;

[18] article 109 f (2 & 3)
[19] article 105 (1)
[20] article 106 (1)
[21] article 106 (3)

- to contribute to the smooth conduct of policies relating to the prudential supervision of credit institutions and the stability of the financial system.[22]

ii. European Central Bank [ECB]

The independent[23] ECB will be governed by a Governing Council composed of an Executive Board and the Governors of the national central banks. The Executive Board will consist of six members[24] 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[25] within the Union, but 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. Member States may issue coins subject to ECB approval of the volume.[26]

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".[27]

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".[28]

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,

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[22]article 105 (2 & 3)
[23]article 107
[24]article 109 (2)
[25]article 105 (a)
[26]article 105 (a) (2)
[27]article 108 (1)
[28]article 109e (1)

loans and marketable securities. Stage 2 also breathed life into the Community's new institutions, the EMI and the Monetary Committee (described above).

According to the Treaty the actual date of transition to Stage 3 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 which, 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.[29]

If the Council decides that it is an appropriate time, then it will set the date for the start of Stage 3. If the date for the start of Stage 3 has **not** been agreed by the end of 1997 "**the third stage will start on 1 January 1999**".[30] The Council Decision at the Cannes summit decided that 1997 would not be the starting date for Stage 3 and hence 1999 is the operative date. Under proposals announced by the Commission, the cut-off date for the examination of the economic data will be late April 1998, in time for the Council meeting scheduled to be held in Brussels in the first week of May.[31] This date allows for the Commission and others to have access to full year 1997 data to make their assessment and judgement.

The outcome of the examination for convergence and the establishment of the timetable 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".[32]

2. Stage 3

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

The value of the ECU (now known as the euro) will be irrevocably fixed according to the decision-making procedures laid down within the framework of the European Monetary System 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

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[29] article 109j (3)
[30] article 109j (4)
[31] *Financial Times* 7 April 1997
[32] article 109 k (2)

> 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.[33]

E. The United Kingdom's opt-out

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 here:

- The UK cannot move to the third stage without a separate decision to do so by its government and Parliament.
- The UK would have had to decide whether to move formally to Stage 3 before the Heads of Government Council meeting that took place before the end of 1996, but since no date was 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.

How far, and for how long, the United Kingdom can 'opt out' of monetary union has always been controversial. The Government's argument is simple: the opt-out is legally binding and watertight and means that the UK is bound by nothing. Other commentators, however, have argued that ratification of the Treaty binds the UK to accepting Stage 3 in principle and therefore that our opt-out is worthless.[34] Furthermore, it has sometimes been argued that the UK's acceptance of the founding treaties or the Community, binding Members to ever closer political and economic unity would ultimately override the protection offered by the opt-out.[35]

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[33] article 109 1 (4)

[34] Martin Howe,*"Monetary Policy After Maastricht: how much independence will Britain possess"*, 1992

[35] See for example Common Provisions Articles A & B, Treaty establishing the European Community, Cm 3151

IV The economic arguments for monetary union

A. Introduction

One of the difficulties in assessing the arguments for a single currency is in first defining the status quo: with what economic arrangement is EMU being compared? At one extreme it could be with a loose, free trade area, with little or no formal economic or institutional linkages. Alternatively, it could be compared with 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 other pooling of economic sovereignty.

In its analysis of the costs and benefits of EMU, the Commission in its study 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"[36]

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

> "About half the Community could proceed now to EMU with little difficulty, notably with their advanced degree of convergence in terms of inflation and cost trends. Three others...have some adjustments to make, The two remaining...could with political will, set their sights on participation in the full EMU, at the same time as the rest of the Community"[37]

The rest of this Section examines the economic case for EMU and follows the Commission's analysis under their four major headings, efficiency & growth, price stability, public finance, and adjustment to economic shocks.

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[36]European Commission, *"One market, one money"*, European Economy No 44 1990 p 9
[37]op cit p 12

B. Efficiency & Growth

Surprisingly, the most obvious (obvious at least to the general public) cost associated with the existence of different currencies 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 and so on. On return to London, having visited all Member States, but without spending any real money, the traveller is 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, the Governor of the Bank of England has argued 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!"[38]

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 Treasury's 'Panel of Independent Forecasters (the Wise Men)' 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.[39] 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 goods in foreign shops simply because they cannot divide by the exchange rate accurately in their head. This effect also takes place at an industrial level and it is claimed that single currency pricing will complement the provisions of the Single Market, 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), but it is clear that volatile exchange rates themselves 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

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[38]Speech at the Association of French Bankers, 31 January 1995

[39]*"Received Wisdom"*, Treasury Occasional Paper No 6, p 23

> income in the Community significantly, possibly up to 5-10% in the long run".[40]

C. Price Stability

The Commission repeated many of the well known arguments that price stability brings with it welfare gains. At its most basic, these arguments are based on the assumption that if an economy functions through 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. The Commission asserted 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 because the operation of monetary policy will be in the hands of the European Central Bank which will have in its constitution a "primary objective...to maintain price stability"[41]. A body with this priority, working independently of countries which have already separately achieved a high degree of price stability (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 also the benefits of low inflation. The better functioning price system might result in higher levels of investment since employers can assess the future prospects for their firm with greater certainty 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, when considering the site of new factories etc, producers can concentrate on 'real' variables, such as labour productivity, location of 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 a lower rate of inflation in the EMU is that the creation of the EMU will affect inflation expectations. If wage bargainers in the EMU expect future inflation to be lower they may respond by lowering their own demands, and thus contribute to the achievement of even lower inflation levels. In a speech in 1995, the Governor of the Bank Of England accepted this view of the likely effects of EMU:

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[40] Commission, op cit p 63
[41] Treaty on European Union, Cm 1934, article 105

> "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."[42]

When, in this changed inflationary environment, governments - who remain in charge of fiscal policy - find out that inflation expectations are lower, the economy could run at higher levels of growth of output, and hence employment, than could have been allowed 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 estimated that the direct benefits to the Community of lower inflation would be of the order of 0.3% of GDP[43], in addition to the much larger gains mentioned above with respect to higher growth of incomes.

D. Public Finance

Even within the generally pro-EMU account given by the Commission in its study, it accepted that there were major implications for public finances in the move to EMU, which would not all be either beneficial or painless in the short term.

According to a Commission spokesman, the two parts of the convergence criterion which deal with public finance, the borrowing and debt criteria, were deliberately set at levels below what was then the then Community average. The reason for this was to reinforce the 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 the Member States, and the specific problems encountered by Germany following reunification, have turned a mildly deflationary aim into a severe test of fiscal commitment. The Commission's analysis was written before this became clear.

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[42]Source: Paris 31 January 1995
[43]Source: op cit p 87

Apart from meeting the convergence criteria, the main problem in this area is that EMU would impose two contradictory impulses on the public finances of Member States. First, in the absence of a nationally determined monetary policy, ie no national interest rate or exchange rate, the need for discretionary fiscal policy to meet national conditions increases. However, 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."[44]

The Commission also pointed out that the benefit of the lower average levels of inflation to be expected within the EMU would put a corresponding burden on governments. For governments, inflation is an effective means of raising revenue. Revenue from taxes such as VAT automatically rises 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 being seen 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 might be in excess of 1% of GDP in some Member States.

E. Adjustment without an external exchange rate

The loss of an exchange rate as a policy instrument has important implications for macroeconomic policy. Recent experience in the UK shows that under certain conditions a devaluation of the domestic currency can have a beneficial impact. 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 the Union, Member States would be in a semi-flexible position since the external value of the common currency would 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 by considering shocks to the Union. How would the Union react, for example, to an increase in commodity (oil) prices? In the literature, shocks are divided into two types, symmetric and asymmetrical: shocks that

[44] Commission: op cit p122

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 often discussed 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 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%[45] of the relative changes in income between the two states will be evened out.

Similar events 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 within the monetary union is very 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 between member states.

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 the evidence suggested that factor mobility is much lower in the EU than 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.

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

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

"But there could also be important disadvantages. [Some] people are less sanguine that monetary union will bring about the behavioural changes necessary to ensure the balanced economic development of the separate member countries.

There is particular concern about both the conjunctural and the structural differences between the member countries that might exist at the time that the single currency came into effect....some of those risks are captured by the convergence criteria in the Maastricht Treaty, which seek to ensure that sustainable conjunctural convergence has been achieved before any move to a single currency. And it is why many people insist that the convergence criteria must be very strictly applied when the time comes. I agree with them.

But the Maastricht convergence criteria do not address the deep-seated structural differences within Europe reflected in the generally high levels of unemployment - which differ substantially from one country to another - and which seem unlikely to be substantially eroded by the present cyclical upturn. This problem, which is generally recognized as much the most urgent economic problem facing Europe, needs to be addressed through structural policies such as those being explored by the Commission and debated by the European Council. But it seems quite possible that a part of the answer to the widely differing levels of structural unemployment will need to be relative wage adjustment. It is hard to imagine that this could be brought about through a reduction in nominal wages in the high unemployment countries; and, without that, it is possible that there would be a need for exchange rate

[46]'Bayoumi & Thomas, *"Relative Prices & Economic Adjustment in the US and the EU: a Real Story About European Monetary Union"*, IMF Working Paper 94/65, p 17

adjustment to help bring about a real wage adjustment."[47]

The Commission's answer to concerns about 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, it has to be accepted that adjustment might well not be a painless process. This is particularly the case if the economy has low inflation. Then, reductions in real wage costs cannot easily be effected by maintaining nominal values and allowing inflation to reduce their value. An historical illustration of the problems of the adjustment process with fixed exchange rates is the experience of the UK following the return to the gold standard in 1925.

The reasons why the country reverted back to the gold standard have been debated at length. Many commentators have stressed that the attraction was the prospect of 'sound money' which could be achieved less painfully on 'gold' than outside the system. Whatever the reason, return did not achieve the goals set out for it, trade did not recover and the economy remained weak. One consequence of this was the appallingly high level of unemployment that persisted in some areas until the outbreak of War.

There has been a good deal of speculation about 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 which then existed in the labour market such as the high levels of unionisation of the workforce; a phenomena which

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[47] Speech in Paris 31 January 1995

[48] op cit p 137

was common to both Germany and the UK. These rigidities may explain why 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.

When the Commission looked at the question of factor price adjustment, they specifically examined real wage rigidities. They argued that the greater credibility of inflation control in the Union, plus the controls on 'fiscal bail-outs' implied in Maastricht would increase labour market 'realism'.[49] However, they also accepted that to the extent that there was a social dimension to the Union's policies, unrestrained income differentials were unlikely to be acceptable (a factor mentioned again in the Commission's White Paper on Competitiveness published in 1994) and legislation covering minimum wages could create a wage norm and institutionalise wage rigidity in some countries. The 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 argument 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, can an institution set up by a Treaty agreed by Member States can really be described as being unrepresentative? In a sense it is like the judiciary in the UK. They are non-elected but their authority is accepted no less for that. Since many Member States already had independent or quasi independent central banks before Maastricht concerns about the constitutional problem are less common on the continent than here.

Secondly, one could question how much economic sovereignty a nation actually has in today's world. It is clear that in a world without controls on capital movements, no single government can 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 a government can do only two of the following things at any one time:

- control international capital movements

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[49] op cit p 149
[50] op cit p 151

- fix the exchange rate
- fix the interest rate

What it cannot do is control all three.

The UK abolished capital controls progressively from 1979, so even outside of the ERM its choice was already limited. If, for example, the market exchange rate is fixed, several other policy options fall into place. 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. Clearly, if monetary policy is fixed by the ECB, then the fiscal choices remaining for a country in the monetary union are correspondingly reduced too. This limitation is given expression in the Maastricht Treaty, which limits government fiscal policy until monetary union and prohibits central government 'bail outs' or rescues of bankrupt public undertakings, broadly defined.[51]

The Commission's analysis generally portrays EMU in a good light. Some leading UK economists, including at least two of the six 'wise men' advising the Chancellor of the Exchequer, have, however, expressed doubts about the Commission's claims.

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

> the French and Italian governments' enthusiasm for EMU arises partly from a wish to dilute German influence in the EMS, not to entrench it. The political will to control inflation is likely to be weaker in the EMU than it is at present.[52]

Congdon also finds that the benefits of transaction cost savings are by and large ascribable not to the existence of one currency but would arise anyway if financial markets were fully deregulated and integrated. At the time that the Commission was writing, most 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 alleged benefits arising from the improved flow of investment funds unconvincing. Since the UK was then the largest recipient of inward investment and was not a member of the ERM, he concluded that factors other than exchange

[51] Cm 1934, Articles 104 & 104c
[52] *"EMU now?, the leap to European money assessed"*, Centre for Policy Studies pamphlet, p 18

rate stability determined major investment decisions. He concluded 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.[53]

Another recent review of the case for joining or abstaining from membership concluded that:

> It should be evident from the above discussion that the calculus of economic gains and costs from EMU is still very uncertain. There could be substantial gains in prospect for the UK from participation, but there are also significant risks. The risks arise partly because the UK economy is not as closely integrated with the core economies as it should be for permanent locking of exchange rates and pooling of monetary policy; partly because the European economies exhibit structural imbalances, especially labour market divergences, which do not seem on the way to correction, and may even be widening; and partly because there is a possibility that the new policy regime will not work well. The latter doubts stem partly from institutional deficiencies in the Maastricht model and partly from the possibility that EMU will be joined in time by states that have not securely converged, or that wish to pursue conflicting economic objectives. The consequences for the UK of participating in an EMU that functions badly could be worse than those of not participating in an EMU that works well.
>
> In the circumstances there is a case for keeping an open mind on early participation in EMU, but with certain crucial provisos. There would be some point in suspending judgement only if there is a prospect that in the meantime the vital issues will become clearer. That may not apply to the purely political issues at stake, which are comparatively timeless, and if joining EMU were solely a matter of political choice..there would be little to gain from hesitation. But if the economic consequences are an important ingredient in the political choice, as they must surely be, more time for consideration should help. For that reason the Government was wise at Maastricht not to commit this country

[53] op cit p22

to participation in 1999 regardless of circumstances.

Among the issues that should become clearer in due course are:

- whether the UK economy has genuinely converged with the core group, in real as well as nominal terms, and whether other candidate states with doubtful convergence records have also done so;

- whether unemployment in the core states is on a downward trend, without producing large payments imbalances that require correction through exchange-rate adjustment; whether the ECB will formulate and conduct monetary policy on lines acceptable to the UK;

- how much flexibility EMU governments propose to allow for fiscal policy in Stage 3; how relations between 'ins' and 'outs' are to be conducted, including exchange-rate arrangements, macroeconomic policy consultation, and access to the payments and settlement system of EMU;

- and whether modifications could be introduced in the Maastricht blueprint to attenuate the fiscal limits, strengthen the accountability of monetary policy, and provide regular consultation between ministers and the ECB on the monetary-fiscal policy mix in EMU.[54]

An alternative way of looking at the advantages and disadvantages to the UK of EMU participation is to focus on its possible impact on specific issues or sectors that are important to the UK. Two identifiable areas are considered below, the City and inward investment.

F. What will EMU mean for the City?

Of course there is an immediate problem with this question, the City is made up of a variety of professions and activities that are both interrelated and yet may have distinct interests. This section tries to look at the responses and problems faced by these separate groups and starts by looking at the coordinating role being played by the Bank of England.

1. Coordination work by the Bank of England

Away from the economic and political arguments about the merits and extent of a single currency, the Bank of England has taken a lead role in co-ordinating practical preparations.

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[54] John Arrowsmith & Christopher Taylor, "Moving Towards EMU: The challenges ahead" *National Institute Economic Review*, October 1996, p87

This work is designed to ensure that the UK's financial and corporate sectors are able to operate should the single currency go ahead, whether or not the UK is a participant. The Bank is issuing progress reports on its work in this area on a roughly quarterly basis. Its third report, *Practical issues arising from the introduction of the Euro*, was published in December 1996. The discussions, which have involved a wide range of market participants and representative organisations, concentrate on such issues as the need to secure the continuity of contracts, providing where necessary for settlement in or convertibility into the Euro, and ensuring that systems and machinery could cope with dual currencies during a transition period. In general, the wholesale markets and international markets will be affected to a greater degree and sooner by the Euro than will markets which are chiefly domestic, whether or not the UK is 'in'. Apart from the securities sector, the implications for personal finance and the retail sector would depend on whether and when Euro notes and coins were introduced into the UK.

2. Gilts

The Bank of England has already taken steps to alter its operations in the money markets, from March 1997, by including gilt sales and repurchases (repos) among its instruments. It will also deal with a wider range of participants rather than acting through the discount houses alone. These changes are both compatible with the system of monetary control which the ECB will operate. The Working Group on the Gilt Market after EMU has reported on other technical issues including the mechanism for the conversion of gilts into euros if the UK joins, and the benefits of greater harmonisation of market practices in Europe.

3. Futures Exchanges

There is fierce competition between the main futures exchanges to retain and expand their shares in the new market. The London market LIFFE, has already introduced new products designed to ensure preparedness if monetary union goes ahead. This is necessary whether the UK joins or not. However, the competitor exchanges in Frankfurt (DTB) and Paris (Matif) are also introducing products tailored for EMU. Competition is expected to be fiercest in the short term interest rate derivatives market where several currencies are currently actively traded but which will shrink to just the euro. LIFFE's 3 month DMark contract is very strong, and it intends to make this contract convertible into euros. There is, however, expected to be room for only one product in the liquid short term market which means that whichever exchange is able to attract the new business in euro futures may squeeze out the other two.[55]

4. Foreign Exchange

55 Sources: 'Post-EMU: credit risk will replace currency risk in the EMU bloc', Bronwyn Curtis, Nomura Research Institute in *Bond Review*, LIFFE, Q4 1996; 'Exchanges square up for a fight', *Financial Times*, 17 December 1996

The City of London is currently the world's largest foreign exchange market with a daily turnover in excess of $450 billion. Trading volumes are expected to fall if a single currency is introduced but supporters point to the relatively small proportion of business which transactions involving European currencies represent. Press reports suggest that markets have become less volatile and that there has been a contraction of employment already, but some expect a significant increase in volatility to return before 1999.[56] Any uncertainty about the participation and timing of countries' entry into monetary union, and the sustainability of the union, would probably increase volumes and volatility. Even after monetary union, traders will want to exploit the relationship between the euro and the major world currencies, and between the euro and non-participating European currencies, including those of Eastern European countries which hope to become members in the future.

5. Banking

A 1995 estimate by the British Bankers Association and the Association for Payment Clearing Services which put conversion costs for the UK banking sector at around £1 billion is now thought to understate the costs. In July 1996 the deputy governor of the Bank of England, Howard Davies, was talking of initial costs of about 3 per cent of annual operating costs, or £1.5 billion for the sector as a whole.[57] Barclays has reportedly produced estimates of £300m for its own costs.[58] A large proportion of the costs for banks will relate to IT and to cash handling machines such as ATMs. Costs for non retail banks are likely to be of a much lower order. A report carried out for the International Securities Market Association suggested that investment banks were already adept at using different currencies in their business, and that their conversion costs would be 'negligible'.[59]

6. Insurance

Research by the Association of British Insurers suggests that the advantages and disadvantages of monetary union for insurers in the UK are finely balanced, although the net effect is expected to be positive. They would be more certain if the market for European insurance expands, which might be expected if monetary union leads to economic growth in Europe, although there are concerns on the investment side should interest rates and investment returns fall.[60] The costs for the insurance sector of monetary union are estimated by the ABI at around £1 billion, with IT costs a significant proportion.[61] The ABI has also cited conversion costs prepared by a relatively small German insurer, specialising in commercial lines, of £20 million for the company. The costs are spread over five years.[62]

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56 'Forex houses sanguine despite possibility of single currency', *Financial Times*, 6 December 1996; 'Banks to struggle as EMU stokes currency volatility', *Reuters News Service UK*, 17 February 1997

57 'BoE's Davies sees change to EMU costing UK banks £1.5 bn', AFX News, 20 June 1996

58 'Banks' early confidence on EMU starts to erode', *Financial Times*, 3 December 1996

59 'Euro conversion costs "negligible"', *Financial Times*, 7 February 1997

60 'The implications of European Monetary Union for UK insurance', *Insurance Trends*, January 1996

61 'Offices may face £1bn in admin costs over EMU', *Money Marketing*, 6 February 1997

62 'Be prepared', *Post Magazine*, 5 December 1996

7. Stock Exchange

The Stock Exchange is able to trade in multiple currencies already, but the use of two main currencies raises a number of practical issues, especially during the transition period. These include the need to retain sterling facilities for private investors until euro notes and coins are introduced and an obligation to calculate consistent market indices. Whilst shares could in theory trade in both euro and sterling denominations during the transition period, that would have an obvious effect on each stock's liquidity. If the UK became a full participant, companies would need to redenominate their capital into euros.

G. Will EMU non-participation affect inward investment intentions?

Prima facie this is an important question for the UK to resolve. The UK has been one of the major recipients of inward investment in the EU over the last fifteen years. Whether one looks at the effect upon the industrial sectors that have acted as hosts, eg car manufacturing, or whether one looks at the powerful stimulus it has had upon the regions where it has been most concentrated the positive and beneficial impact of this inward investment cannot be easily overstated.

There is another reason for looking at this topic. The statistical evidence is that in recent years the UK has already lost some of the projects that might have been expected to have come to this country. The reasons why a country is chosen by another as a host for outward investment are highly complex and vary greatly between projects. The reasons given for the UK as an attractive location are varied:

- high labour quality and flexibility
- low overall costs
- deregulated business environment
- low tax rates
- the English language and ease of communication
- market proximity (inside the EC Single Market)[63]

None of these advantages have suffered any obvious diminution and yet the trend in the proportion of projects coming to the UK is clear as the table below demonstrates:

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[63] *'Competitiveness, Helping Business to Win'*, Cm 2563

UK foreign direct investment **(millions of dollars)**

	FDI flows into:		UK fdi
	EU	UK	as % of EU
1984-89 (average)	37,702	13,545	36%
1990	97,387	32,430	33%
1991	77,715	16,208	21%
1992	79,812	14,934	19%
1993	74,467	14,475	19%
1994	64,017	10,085	16%
1995	111,920	29,910	27%

Source: UN World Investment Report 1996

The figures demonstrate that for some reason the UK now gets about 15% less of the total EU fdi in the five years after 1989 than it did in the five years leading up to it. Support for the view that membership of EMU was a crucial factor in the location decisions made by business investors was heightened by comments made by the President of Toyota, Hiroshi Okuda. Mr Okuda is reported to have said that the company's future strategy towards the UK would change if the UK stayed outside EMU. This did not mean decreasing the level of investment, but that Toyota would "leave investments as they are now". It would prefer to make any new investments in continental Europe than in the UK.[64] The views of one industrialist, however, important, is not proof positive of any particular proposition, and it was noticeable that other industrialists in a similar position, Honda and Nissan for example, did not wish to be associated with Toyota's comments. A recent study by economists from the National Institute, however, have reinforced the doubts about the potential negative impact of non-participation.[65] The authors conclude that:

> Membership of the EU and access to the EU market are important factors behind the high level of inward investment. Labour costs and tax competitiveness do matter, but only if a firm wishes to locate within the EU. However, if these were the sole factors in investment decisions it would be difficult to account for the continued level of high outward investment from the UK.
>
> There is plenty of empirical evidence that exchange rate volatility affects investment decisions. Investors may seek to minimise foreign exchange risks by locating close to their final market so that their costs and revenues are denominated i the same currency. If the UK remains outside any eventual monetary union, foreign investors whose primary markets are in continental Europe have an incentive to choose to locate there rather than in the UK.

[64] Reported *Financial Times* 30 January 1997
[65] *'EU: an attractive investment',* Ray Barrel & Nigel Pain, New Economy, Spring 1997

Outside the EMU, the UK would have to compete for inward investment with other countries on the periphery of the EU, notably those in central Europe, with lower labour costs and closer proximity to some of the key national markets within Europe. [66]

[66] op cit pp54-5

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. These include:

- Treasury Committee: *'The prognosis for stage three of economic & monetary union'*, HC 283, 1995-96
- 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'* (various).
- 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 considered later in connection with the position on convergence. The Commission's documents were the subject of debate about both the appropriate Parliamentary procedure for their scrutiny and about what they implied for the UK.[67] The section below looks solely at the technical content of these documents plus other matters that have been decided post-Treaty.

B. Technical developments

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

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 the final section of this Paper.

i Price Stability

Further work has been carried out by the EMI to define more carefully what the Treaty criterion means since it is unspecific on some matters. 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"*. The EMI have decided, for the time being at least, not to rule one way or another on the meaning of this phrase. Although the EMI 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 given for this 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 inclusion would produce. Currently, however, this is an objection which is more imagined than actual.

Work on the harmonisation of consumer price indices across Member States, since considerable differences currently exist in the way that different countries calculate 'inflation', is now complete. A Council Regulation[68] adopted in October 1995, established a framework for the detailed harmonisation work and final harmonised (HICPs) indices were published on March 7th 1997. It is the HICPs that will be used as the basis for the convergence assessment in 1998.

The main areas that required examination were, for example, owner-occupier housing costs, insurance, health care and foreign holidays, all items subject to differing treatment in Member States. Adjusting for 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.

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

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

ii Exchange Rate Stability

Ever since the ERM crisis in the summer of 1993, the exchange rate criterion has been difficult to interpret. Opinions, even at the highest levels of decision making, disagree over its exact meaning. It is possible to argue both that nothing fundamental has changed, or that there is no real criterion left to discuss. For example, during his statement to the House on his return from the Madrid summit in December 1995, the Prime Minister expressed the view that membership of the ERM was not a necessary condition for meeting this criterion:

> 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.[69]

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.[70]

[69] HC Deb 18th December 1995, c1227
[70] HC Deb 9th January 1996 c114w

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

When the protocol was drafted, all Member States except for Greece were in the ERM, and there had been no general realignment of currencies since 1987. The wording of the Treaty implicitly assumed that this would be the future pattern:

> *"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."*

There remains some doubt about the meaning of the phrase "severe tensions". When the Treaty was drafted the fluctuation margins were a convenient benchmark of severe tension, but there are other possible measures and the approach of the EMI in its reports has been to present a range of measures of exchange rate stability.

There has also been some debate about what constitute 'normal' fluctuation bands. Following the widening of the 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 no more than 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, 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."[71]

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

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

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

> "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 requirement 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[72]"

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."[73]

This crucial issue of ERM membership should have already been decided upon. As the Prime Minister pointed out in his written answer (see above), 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 could, therefore, preclude a Member State from joining the original group of EMU entrants even if it wanted to and thought it in its best interest to do so. 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 to that effect.

iii Interest Rate Criterion

Since the interest rate threshold is calculated with reference to the countries with the best

[72]Progress Towards Convergence, 1995, p33
[73]EMI Annual Report 1996 p 41

inflation performance, the basis of determination under that heading determines the choice of countries under this heading too. The choice of debt instruments 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. If several bonds fall within this definition a simple average can be taken.

iv Government debt and borrowing criterion

There have been several developments in the interpretation of these criteria. Pre-privatisation debt write-offs of public corporations are now counted towards reductions in the government's deficit. This decision has benefited the UK: the 1995 deficit was reduced by 0.2% of GDP and the 1995/96 deficit by 0.1% from 5.1% to 5.0% of GDP.[74]

There has, however, been some concern over the extent to which certain Member States have used a variety of devices to reduce their borrowing or indebtedness. The French government, for example, in its drive to meet the Maastricht criteria has included in its plans a £4.6 billion one-off contribution in respect of pension contributions from the partial privatisation of France Telecom. Belgium is one of several countries whose budgets are projected to be on or just within the 3% of GDP mark by the end of 1997. According to a report in the *Financial Times*[75] this improvement was effected by a combination of expenditure cuts of £1.63 billion and debt reduction measures worth £7.5 billion including a one-off sale of central bank gold reserves worth £4.5 billion.

Italy too has been subject to scrutiny on the measures that it has announced. Particular attention has focused upon a 'Eurotax' introduced by the government to reduce the deficit by 0.5% of gdp. What has caused comment is the fact that part of this tax is due to be remitted to taxpayers in 1999 and hence it is seen as a short term palliative to a long term structural problem. Eurostat have also had to rule on the correct treatment of a tax on 'wage funds' which is held on the balance sheet of employers until the sums are withdrawn. The Italian government decreed that employers had to pay 2% of the amounts accumulated in 1997 and the rest in due course: effectively bringing forward the date of payment. Eurostat ruled that this was a new tax, effectively reducing the Italian deficit by 0.19% for 1997.[76]

Definitional matters such as these are decide upon in the first instance by a committee of statisticians from Eurostat. It was reported in the press that Eurostat had approved the Italian measure as a legitimate reduction in its deficit.[77] In the same report it was stated that Eurostat had also approved of the accounting treatment of the British government's Private Finance Initiative. For the purposes of the criteria, where a private organisation builds and

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[74] ONS Press release: 22 Nov 1996
[75] *Financial Times* October 2 1996
[76] Eurostat Press Release, 21 February 1997
[77] Financial Times, 23rd February 1997

pays for an asset the ownership of which later reverts to the government, the investment should count towards the government's deficit. There is no impact on government debt however, since medium to long term credit by government for the private sector is excluded. By contrast, if the ownership of the asset stays with the private enterprise that builds it, there is no impact on either the debt or deficit figures.

v 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, at their meeting in Madrid in December 1995, the European Council approved a 'reference scenario' for the changeover to the single currency which had been 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 in 1998 which Member States are to go forward into monetary union they will have to do this on the basis of economic data for 1997. Under proposals announced by the Commission, the cut-off date for the examination of the economic data will be late April 1998, in time for the Council meeting scheduled to be held in Cardiff.[78] Thus there could be as little as eight months between the publication of the data, the decision about entry being taken and the start of Stage 3.

The name of the new currency will be the **euro,** to be 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 not been fulfilled. Since euros and ecus will be exchanged on a one for one basis[79] 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 euro coin will be 2 and that the notes would be in units of 5, 10, 20, 50, 100, 200 and 500 euros[80]. With such high value notes (500 euros = about £400) the technical standard for forgery proof notes is very high indeed.

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[78]*Financial Times* 1 March 1997

[79]See Madrid Presidency Conclusions, p 7

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

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 introduction of the new currency. 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, while such systems in other Member States which do not participate 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 (on 1st January 2002) to issue euro banknotes and coins (with national central banks) These will initially 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 130,000 cash dispensers to the new currency.[81] Also the EMI wanted to strike a balance between a big bang approach, with all changes happening straightaway, and a lengthy 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

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[81] op cit, EMI p 22

account.[82]

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 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 euro currencies. Withdrawals from cash dispensers 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 direct costs of the entire changeover. This dual period could last six months. Other

[82] op cit, EMI p23

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 published in September 1996. 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.[83]

i The stability pact

It has long been accepted that it would be necessary to set up a 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 the agreement was a Franco-German summit held in the Summer of 1996 where various ideas for fiscal discipline were put forward. It was agreed that the pact would be based upon what is currently in Articles 103 and 104(c) of the Maastricht Treaty, which is the basis for the surveillance procedure and the excessive deficits procedure in Stage 2 of EMU, thus there is no need to renegotiate the Treaty. The draft plan was that Member governments should have a continuing duty to present budget plans to other Member States who, by a system of qualified majority voting, would decide whether an excessive deficit situation existed.

Agreement was finally reached on the details of the pact at the Dublin Council Summit after, from what one can gather, were long arguments about the definition of *'normal circumstances'*.

[83] HC Deb 25th Nov 1996 c21-24

The obstacle in the path of an agreement on the pact had been 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[84] 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. The pact, now called the stability and growth pact, was outlined in the Presidency conclusions to the Summit. It requires Member States to aim for a medium term budgetary position of close to balance or in surplus. At the heart of the pact is a series of steps designed to bring a Member State back to the path of fiscal rectitude.

The trigger for the procedure is whenever the actual or planned government deficit exceeds 3% of GDP. If the deficit is accompanied by an annual fall in real GDP, the sanctions that might otherwise apply automatically may only apply at the discretion of the Council, depending on the extent of the fall in GDP. If the fall is at least 2% of real GDP then the excess is deemed to be exceptional and hence outside of the control of the relevant member state and the excessive deficit procedure is not activated. If the annual decline is less than 2% but more than 0.75% of GDP the recession is defined as being severe. A deficit in excess of 3% concurrent with a severe recession gives the Council some leeway in deciding whether or not an excessive deficit exists or not. The Council in these cases will make their decision, in the words of the Presidency's conclusions:

> "in the light of further supporting evidence, in particular on the abruptness of the downturn or on the accumulated loss of output relative to past trends".

If an excessive deficit exists and there are no extenuating circumstances, the Commission and the Council will study the budget plans of that Member State in the same way as they examine the convergence plans submitted now. Recommendations will then be made to the State that appears to have a deteriorating deficit position. Member States have a period of four months within which to take "effective action" and a period of one year within which the deficit should be brought within acceptable bounds. If a Member States does not take the required steps (in practice it would appear as though, at least in the first instance, all that is required is a public announcement of intended measures) then within ten months of the excessive deficit situation being pronounced, it will be liable for sanctions. Initially these will be non- interest bearing deposits but which can convert into fines after two years if the deficit persists.

The deposits/fines will be made up of a fixed component equal to 0.2% of GDP and a variable component equal to one tenth of the excess of the deficit over the reference value of 3% of GDP. There will be an upper limit of 0.5% of GDP for the annual amount of deposits. The amount of the sanction will be based on outcomes for the year in which the excessive deficit occurred.

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[84] 11th November 1996

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 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.[85]

Whilst it may be the case that "the Stability Pact makes good economic sense for the UK", it is nonetheless instructive to look at the impact that this proposal will have on the economy. There are problems in doing this. First, the data that will be scrutinised in the future is not the same as that which was available in the past. Secondly, until a body of decisions builds up it is difficult to predict the degree of rigour with which punitive sanctions will be enforced. The table opposite, however, looks at the period 1970-1996 from the perspective of the stability pact provisions. The first column shows the real growth of the UK economy over the year. The next column shows the government's deficit as a percentage of GDP. The last, right-hand, column indicates the likelihood that the Commission/Council would have invoked the penalties procedure as indicated by the details available under the pact.

[85] HC Deb 25th Nov 1996 c21-24

EMU growth & stability pact

	Growth in GDP constant prices	Government deficit (a)	Fiscal restraint
1970	na	-0.1%	
1971	1.68	2.3%	
1972	2.78	3.0%	yes
1973	7.54	5.5%	yes
1974	-1.48	7.7%	possible
1975	-0.75	9.6%	possible
1976	2.66	7.1%	yes
1977	2.58	3.7%	yes
1978	2.76	4.9%	yes
1979	2.75	6.3%	yes
1980	-2.06	5.1%	possible
1981	-1.13	4.1%	possible
1982	1.77	1.7%	
1983	3.74	3.8%	yes
1984	2.01	3.2%	yes
1985	4.02	2.1%	
1986	4.01	0.6%	
1987	4.62	-0.3%	
1988	4.94	-2.5%	
1989	2.25	-1.8%	
1990	0.56	-0.4%	
1991	-2.08	1.3%	
1992	-0.52	4.8%	yes
1993	2.21	6.7%	yes
1994	3.98	5.7%	yes
1995	2.55	5.0%	yes
1996	2.34	3.4%	yes

Note: Government deficit defined as PSBR/GDP

Source: ONS Database

The table indicates that in approximately half of the years under consideration the UK would have been in contravention of the pact. In a further four years, the statistics indicate that the Council may have considered the UK to have been so. One cannot necessarily infer from this table that the UK would have had to have made payments, although it might. What it does suggest, however, is that UK fiscal policy would have been subject to positive scrutiny by the EC for approximately two thirds of the entire period.

ii Legal framework for the use of the euro

Commission Document 96/499 sets out the legal framework for the use of the euro. This has to be introduced in order to permit the euro to be used in Sage 3. Although in the planning

stage of EMU, reference was made to the ECU as the common currency, it was never intended that the EMU ECU would be the same as the current ECU. The current ECU is composed of a basket of currencies and has no independent value. The new common currency, the euro, will have a value determined by the markets independent of those Member Sates' currencies which remain after EMU (the outs). Obviously the currencies of the 'ins' will vanish.

At a practical level the regulation provides 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; and 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.

The legal basis upon which this directive 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, in the light of the consequences for financial markets of continuing the uncertainty about these matters, it was thought unwise for a decision to be delayed any longer.

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 have little effect on the UK since we are not in the ERM and our opt-out exempts us from most of the convergence programmes. This document is less specific than the other two and contains fewer proposals. It is backed up by a discussion document from the European Monetary Institute.[86] 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

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[86]Com doc 10526/96

Rome.[87]

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'[88]. The central rates would be set by 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 and 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 description of the system, however, it would not appear to be the intention that the new system would evolve into a replica of as the old ERM. The legal basis for the new ERM 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. Although there has been much debate since then the central, official, position has not changed and since it has been referred to by other Ministers in later debates it is worth quoting at some length.

> "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

[87]op cit HC Deb Nov 1996
[88]Com Doc 10526/96

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."[89]

The Labour Party's position is set out below:

> On the single currency we have made it clear that it is a major step of economic integration, which in principle could bring benefits in terms of stability and lower interest rates. The issue must be determined by a hard-headed look at its economic practicalities. For Britain to enter, we would need to be convinced that economic conditions would allow it to succeed. We will make a decision on the basis of the economic merits of the case, when the arguments for Britain are clear. And if we decide that Britain should join the single currency in the next parliament, then there will be a referendum to gain the consent of the people. In the past, Europe has been driven forward by a small elite. In future, we must make sure the direction and speed of progress have the people's backing.[90]

The announcement by the Labour Party that they would hold a referendum on the question of EMU membership before entry brings the Party close to the position held by the Government, as described by the Prime Minister:

> 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.[91]

Subsequently, Labour expanded on what the economic criteria would be for it to decide on whether to recommend membership:

> Britain will only join if the terms and conditions are right and the tests that will be applied will be 'British tests'. As well as the Maastricht test - a series of convergence criteria setting tough economic targets as conditions of

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[89] HC Deb 1 March 1995 cc1065-1071
[90] http://www.labour.org.uk:80/britains_future/index.html
[91] HC Deb 12 March 1996 c780-781

membership - a Labour government would set five British requirements:

- The likely impact on investment by British firms in Britain and Europe and on inward investment to Britain;
- The effect on Britain's financial services;
- Whether European countries were at different stages of the economic cycle;
- Whether there was sufficient flexibility to respond to any shocks;
- The likely impact on jobs.[92]

The likely impact of these criteria were examined in a press article.

> the five criteria do not yet clearly determine whether Labour would join in the first wave or not. Graham Bishop of Salomon Brothers said: 'On balance these criteria will enhance the chances of the Labour Party joining EMU.' However, Michael Lewis of Deutsche Morgan Grenfall said: 'These criteria form a more rigorous test; they would push you away from joining in the first wave and towards waiting to see how EMU panned out.' Mr Brown's first criterion is to 'examine the likely impact on investment by British firms . . . and on inward investment'. Fears are already growing that an opted-out Britain could lose inward investment as companies such as Toyota consider relocation within the euro-zone. Moreover, if the euro is a strong currency, interest rates in Britain are likely to be higher than in the euro-zone, discouraging investment by British companies, too. The risk of lower investment, growth and job creation outside EMU would, according to Mr Bishop, be 'bound to have a significant impact on a party that cares about unemployment'. Employment, after all, is another of Mr Brown's criteria. But Mr Lewis argues that concern for investment would not necessarily lead to early membership: 'That's more a long-term consideration.' Mr Brown plans as well to consider 'the effect on our financial services'. However, a recent report by David Currie for the Economist Intelligence Unit argues that financial services should in fact do well inside or outside EMU so long as they prepare properly, keeping Mr Brown's options wide open.
>
> The shadow chancellor also said, 'we will examine whether European countries are at different stages of the economic cycle'. Britain is currently in its fifth year of economic growth, while the German economy actually shrank in the

[92] *Press Association*, 19 February 1997

> last few months of 1996. According to Mr Lewis: 'this condition could delay Britain's entry for some time.' However, the single currency could itself speed the integration of economies and reduce the need for separate monetary policies across the union.
>
> The final Labour criterion is to examine whether there is sufficient flexibility in the Dublin stability pact to cope with economic shocks. As the David Currie report points out, unable to use monetary policy to react to local economic problems, governments will need the freedom to adjust borrowing to tide them through bad times. A strict interpretation of the stability pact - as the Germans prefer - would remove much of that flexibility. Mr Lewis said: 'It looks as though Labour wants to wait and see how much discretion national governments will have.[93]

From a political perspective, however, the additional five criteria, if anything, bring the two main parties' attitudes closer still. Three of Labour's five - impact on the City, impact on inward investment and employment- were foreshadowed in the Prime Minister's Hansard speech (see above).

The attitude of business and industry towards EMU remains mixed. Virtually all the mainline positions (join early, wait-and-see, stay out) are represented by different City or industrial interests and all persuasions can produce a famous or influential industrialist to espouse one position or another. In past years it was noticeably easier to find examples of anti-emu views than more positive comments. However, this is no longer true and there is greater parity between the two camps now than there once was. This could be due to a more equal effort on behalf of both camps to publicise their views rather than a fundamental shift of opinion, however, it is a noticeable trend.

One example of the change in attitude can be found in successive polls carried out on their members by the CBI. In a poll published in November 1995 the CBI found that:

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

[93] 'Labour outlines single currency criteria for joining in 'first wave', *The Independent* 21 February 97

part of the leading group.[94]

However, a similar poll of the same members taken a year later found:

- only 7% of businesses were radically opposed to Maastricht;
- 56% of businesses supported the principle of EMU; and
- 28% thought that the UK should be part of the leading group.[95]

A similar shift in views took place amongst exporters, in a survey carried out by a credit insurance group. When asked in 1995 "do you wish to see a single currency in Europe?", exporters, who might be expected to benefit most from the single currency, returned a 54% 'no' vote and a 36% 'yes' vote. One year later, however, the gap had narrowed considerably, 48% now voted 'no', 43% 'yes'.[96]

Despite the observable swing in sentiment, it is still the case that the reaction of the business community to EMU remains mixed, with both sides able to find important industrialists to back their views. Critics of EMU include Sir John Hoskyns, Chairman of Burton clothing group, Sir Alick Rankin, Chairman of Scottish & Newcastle brewing, Bill Hughes, Chairman of Grampian Holdings and Sir Stanley Kalms of Dixons who, said about the CBI survey that, "Fortunately the serious media have dismissed [their] conclusions"[97]

The greatest support for EMU from industrialists appears to come from the petro-chemical sector. ICI has emerged as one of the most vocal supporters of EMU:

> In the long run I am sure that the UK being outside a single currency would affect investments. It could pull Europe apart.

and

> ICI would definitely be concerned if the UK were outside a single currency-

[94] *Independent* , 7 Nov 1995
[95] *Independent*, 11 Nov 1996
[96] NCM Credit Insurance Survey, October 1995 & July 1996
[97] *Financial Times* , 8 March 1996

> it would reduce the country's attractiveness to investors and reinforce the perception that the UK was not committed to Europe as a trading bloc.[98]

Another businessman to express concern about the UK should it remain outside of the single currency was Sir Iain Vallance, Chairman of British Telecom. He is reported as saying that:

> Britain could not remain permanently outside of the single currency zone or escape some sort of "supranational monetary discipline" if it wanted to enjoy the benefits of the single market. "Retaliation is definitely on the cards. There are enough people talking about it already"[99]

Small and medium sized firms (sme's) too generally supported EMU. A poll of 81 companies revealed[100] that:

Financial Times poll on attitudes amongst SMEs to EMU

	Yes	No	Neutral
UK should delay joining	64	29	7
UK should join at some stage	73	20	7
UK will wait until after 1999	77	16	7
UK will never join	10	83	7

The TUC has become very strongly pro-Europe. In an interview, the TUC General 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"[101]

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[98] op cit
[99] *Financial Times*, 10 July 1996
[100] *'Broad Support but doubts on the timetable'*, Financial Times, 10 March 1997
[101] *Financial Times* , 27 December 1995

In fact trade unions have developed a broad pro-Europe theme, nurtured not only by considerations of the advantages of EMU but also by an enthusiasm for the provisions of the 'social chapter' and EU based rules for worker protection.

The business/commercial organisation expressing the strongest anti-EMU sentiments is the Institute of Directors. A survey of its members in July 1996 revealed that only 31% supported EMU membership.[102] Other aspects of European integration, however, were popular: both the single market and future enlargement were both supported by large majorities of the membership. The main argument against EMU was the fear of inappropriate interest rate decisions:

> Inappropriate interest rate policies can damage the business community and the wider economy. People are still suffering from the effects of the over-tight monetary policy that was forced on Britain as a member of the ERM. This could well happen if we joined EMU but this time there would be no escape route.[103]

Another high profile anti-EMU declaration was made by the chief executive of Barclays Bank, Mr Martin Taylor. His argument was that the UK should not consider joining a monetary union until its economic cycle had converged more closely with that of the continent.

> Britain should not go into EMU in the foreseeable future because no one knows at what rate it should do so. You could pick - and justify - any number between DM 2.20 and DM 2.90[104]

Opinion polls of the attitudes of ordinary people across Europe to EMU appear regularly. The impression gained from looking at these over a period of time, particularly on mainland Europe, is that sentiment is moving in the opposite direction to that demonstrated by business. Two questions from a recent poll covering Great Britain, Germany, France and Italy are shown below:

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[102] 'Company Directors say 'No' to the Euro', *Sunday Business,* 21 July 1996
[103] Comments by IOD director General, op cit
[104] Financial Times 26th March 1997

If a referendum were held during the next few months, how would you vote, in favour or against the creation of a single European currency and the abolition of your national currency?

	Britain	Germany	France	Italy
In favour	26	43	61	71
Against	56	44	33	12
Wouldn't vote	5	2	2	3
Don't know	14	11	4	13

If a single European currency is created and your country is part of it, do you think that in 10 or 20 years' time your country will be better off as a result, or worse off, or will it not make any difference?

	Britain	Germany	France	Italy
Better off	20	16	53	58
Worse off	42	31	18	8
No difference	16	38	20	20
Don't know	21	14	9	14

Source: Daily Telegraph 10 January 1997

The interesting feature of the replies from nearly all the countries is how they are split between the extreme camps. Only 4% of French people were unsure how they would vote. The Commission is currently very concerned about how to educate the people of Europe on what EMU means. On the evidence of this poll they shouldn't bother: the people of Europe have made up their minds already.

VI The State Of Convergence

A. Introduction

In its convergence assessment in *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 to be paid to the substance and not only to the accounting methods in measuring both deficits and debts.[105]

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. 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 budget deficit procedure. 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 61.

[105] op cit p iii

B. The Convergence Test

1. Achievement of Price Stability.

The convergence 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.*

The final harmonised data have just been published and can be now used for the first time. The benchmark is based on the average of the best three. The Commission seem to suggest[106] that the preferred measure will be the average of the annual year-on-year average rate of inflation in the three Member States with lowest inflation. The data used here are the increases in the harmonised price index of each Member State in the year to January 1997. This is not the methodology which will actually be used in determining who will qualify, but, it does give an indication of current performance. The three lowest inflation rates were Finland (0.9%) and Sweden and Luxembourg (both on 1.3%). The average of these three is 1.2% suggesting a threshold for this criterion of 2.7%. Only three countries had inflation rates above this level; Greece (6.6%), Spain (2.8%) and Portugal (2.8%). Therefore, twelve countries meet the criterion, however, until it is possible to replicate the criterion exactly, using year on year averages, the threshold level is liable to shift considerably from one month to the next. For example, on the basis of the figures for December 1996, twelve countries failed the criterion, mainly due to the existence of a negative inflation figure for Sweden.

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.*

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[106] *European Economy Supp A*, January 1996

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.*

Performance against both parts of this criterion is based upon estimates in the Autumn 1996 economic forecast published by the Commission.

2(a). Government deficit

The data to be used for assessing the budget deficit are general government net borrowing (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 countries exceeded 60% of GDP 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 discussed 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. Ten Member States passed this criterion, a substantial increase on the performance in 1995, when the 1993 devaluations of countries such as Spain and Portugal still 'counted'. Finland joined the ERM in October 1996 and Italy rejoined following negotiations with other Member States' central banks on 24th November 1996.

Of course, it is not possible for two of the three new members, Finland or Sweden, to have met this test prior to their accession. The Austrian schilling, however, joined the ERM soon after accession and has now qualified. The Finnish Maarka joined in October 1996 and hence could be ready before the 1st January 1999 deadline at least.

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 for the last quarter of 1996, with the exception of Ireland and the Netherlands for which third quarter figures are used. Among those countries with the three lowest inflation rates (Finland, Sweden and Luxembourg) the average long-term interest rate was 6.4% suggesting a threshold of 8.4%. On this basis only Greece had interest rates above this level.

C. Performance & prospects

On the basis of these data, only Ireland, Denmark 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. There is then another group comprising, Belgium, Germany, Austria and the United Kingdom which pass three each, leaving Spain, Portugal, Finland, Sweden, Greece and Italy on the periphery having failed either three or more tests.

Looked at in terms of the individual criterion, it is the deficit criterion with eleven failures and the debt criterion with ten, which cause the greatest difficulty. The fact that now only three, instead of nine, Member States failed on the inflation criterion illustrates the freakish nature of the failures highlighted the last time that this table was constructed (December 1996), which included a negative inflation outcome for Sweden.

The last table in this Paper looks at the forecast data available for 1997. It is largely on this data that Member States will be judged as candidates for EMU membership. It is also the case that the contrast between what data are available and the way they will be actually judged is at its most distinct. For example, the inflation figures are derived from a deflator of consumers expenditure rather than the RPI-type harmonised figures that will be used by the Commission/Council. The forecasts for the fiscal position are based upon stated Budget plans of Member States and the judgement on meeting the exchange rate criterion is simply that of continuing membership, ie there is a presumption in favour of continuing currency stability.

Despite the attempts by Member States to improve their fiscal performance it remains the case that the debt/deficit measures account for nearly all of the 'failures'. On these figures all countries with the exception of Greece meet the inflation and interest rate criteria. Ten countries fail to meet the debt criterion and three the deficit measure. Assuming that Denmark and Ireland continue to enjoy the derogation on their deficit positions the core of first wave countries on these figures is Denmark, France, Ireland and Luxembourg. Because, however, the same general treatment given to Ireland and Denmark would also be given to other countries, one might expect that the list of qualifiers would be somewhat longer than this. For example, if a member state passed all the other measures, including borrowing under 3% of GDP, and a debt figure of less than 70% were thought to be acceptable (lower than the level of Ireland when it received a derogation) the list of qualifiers would comprise a bloc of seven countries: Denmark, France, Ireland, Luxembourg, Germany, Spain and Portugal.

Appendix

PROTOCOL
ON CERTAIN PROVISIONS
RELATING TO THE UNITED KINGDOM OF GREAT BRITAIN
AND NORTHERN IRELAND

THE HIGH CONTRACTING PARTIES,

RECOGNIZING that the United Kingdom shall not be obliged or committed to move to the third stage of Economic and Monetary Union without a separate decision to do so by its government and Parliament,

NOTING the practice of the government of the United Kingdom to fund its borrowing requirement by the sale of debt to the private sector,

HAVE AGREED the following provisions, which shall be annexed to the Treaty establishing the European Community:

1. The United Kingdom shall notify the Council whether it intends to move to the third stage before the Council makes its assessment under Article 109j(2) of this Treaty.

   Unless the United Kingdom notifies the Council that it intends to move to the third stage, it shall be under no obligation to do so.

   If no date is set for the beginning of the third stage under Article 109j(3) of this Treaty, the United Kingdom may notify its intention to move to the third stage before I January 1998.

2. Paragraphs 3 to 9 shall have effect if the United Kingdom notifies the Council that it does not intend to move to the third stage.

3. The United Kingdom shall not be included among the majority of Member States which fulfil the necessary conditions referred to in the second indent of Article 109j(2) and the first indent of Article 109j(3) of this Treaty.

4. The United Kingdom shall retain its powers in the field of monetary policy according to national law.

5. Articles 3a(2), 104c(1), (9) and (11), 1O5(1) to (5), 105a, 107, 108, 108a, 109, 109a(1) and (2)(b) and 109*l*(4) and (5) of this Treaty shall not apply to the United Kingdom. In these provisions references to the Community or the Member States shall not include the United Kingdom and references to national central banks shall not include the Bank of England.

6. Articles 109e(4) and 109h and i of this Treaty shall continue to apply to the United Kingdom. Articles 109c(4) and 109m shall apply to the United Kingdom as if it had a derogation.

7. The voting rights of the United Kingdom shall be suspended in respect of acts of the Council referred to in the Articles listed in paragraph 5. For this purpose the weighted votes of the United Kingdom shall be excluded from any calculation of a qualified majority under Article 109k(5) of this Treaty.

   The United Kingdom shall also have no right to participate in the appointment of the President, the Vice-President and the other members of the Executive Board of the ECB under Articles 109a(2)(b) and 109*l*(1) of this Treaty.

8. Articles, 3, 4, 6, 7, 9.2, 10.1, 10.3, 11.2,12.1,14, 16, 18 to 20, 22, 23, 26, 27, 30 to 34, 50 and 52 of the Protocol on the Statute of the European System of Central Banks and of the European Central Bank (" the Statute ") shall not apply to the United Kingdom.

   In those Articles, references to the Community or the Member States shall not include the United Kingdom and references to national central banks or shareholders shall not include the Bank of England.

   References in Articles 10.3 and 30.2 of the Statute to " subscribed capital of the ECB " shall not include capital subscribed by the Bank of England.

9. Article 109*l*(3) of this Treaty and Articles 44 to 48 of the Statute shall have effect, whether or not there is any Member State with a derogation, subject to the following amendments:

   (a) References in Article 44 to the tasks of the ECB and the EMI shall include those tasks that still need to be performed in the third stage owing to any decision of the United Kingdom not to move to that stage.

   (b) In addition to the tasks referred to in Article 47 the ECB shall also give advice in relation to and contribute to the preparation of any decision of the Council with regard to the United Kingdom taken in accordance with paragraphs 10(a) and 10(c).

   (c) The Bank of England shall pay up its subscription to the capital of the ECB as a contribution to its operational costs on the same basis as national central banks of Member States with a derogation.

10. If the United Kingdom does not move to the third stage, it may change its notification at any time after the beginning of that stage. In that event:

    (a) The United Kingdom shall have the right to move to the third stage provided only that it satisfies the necessary conditions. The Council, acting at the request of the United Kingdom and under the conditions and in accordance with the procedure laid down in Article 109k(2) of this Treaty, shall decide whether it fulfils the necessary conditions.

    (b) The Bank of England shall pay up its subscribed capital, transfer to the ECB foreign reserve assets and contribute to its reserves on the same basis as the national central bank of a Member State whose derogation has been abrogated.

    (c) The Council, acting under the conditions and in accordance with the procedure laid down in Article 109*l*(5) of this Treaty, shall take all other necessary decisions to enable the United Kingdom to move to the third stage.

    If the United Kingdom moves to the third stage pursuant to the provisions of this protocol, paragraphs 3 to 9 shall cease to have effect.

11. Notwithstanding Articles 104 and 109e(3) of this Treaty and Article 21.1 of the Statute, the government of the United Kingdom may maintain its Ways and Means facility with the Bank of England if and so long as the United Kingdom does not move to the third stage.

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