EMU: the path to Maastricht

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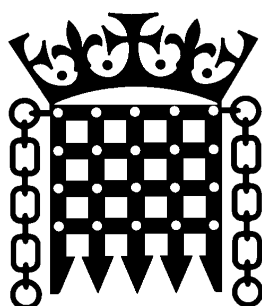

This paper looks at the history of previous attempts by European leaders to create a more unified economic area and at the discussions and arguments that preceded the adoption of the Maastricht Treaty. It outlines the main features of the Maastricht Treaty as the framework for Economic & Monetary Union in Europe and describes the changeover procedure as EMU is brought into being.

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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.

This Paper briefly outlines the history of past attempts at achieving monetary integration. It then explains the more important details of the Maastricht Treaty and outlines the steps to be taken with respect to the move to Stage 3 of 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 to 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 co-ordination 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 that 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 co-operation must move in parallel with progress in monetary co-operation.[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 that superseded Bretton Woods - the Smithsonian agreement of 1971 - European currencies could move bilaterally against each other by up to 9%. In Europe, however, it was felt that 9% was too big a margin to accommodate the workings of Community institutions such as the CAP. The Snake reduced the inter-European currency variations to 4.5%. When the dollar was floated in March 1973 the 'tunnel' effectively disappeared and all that remained was an intra-European exchange rate agreement which was seen as a precursor of the European Monetary System which took over in 1979. The UK joined the 'snake' with Denmark on 1st May 1973 but left on the 23rd June following a short foreign exchange crisis.

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

1 HC Deb 23 October 1972 c.791

2 Op cit c.792

> 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 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 with 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 that was submitted to the European Council meeting in Copenhagen in April 1978. This devised an objective trigger for automatic policy co-ordination 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,

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

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 co-ordinate 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 co-ordinate 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 co-operation 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 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. During the course 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 crises 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) that the cause was speculative attacks on currencies and in logic these attacks were unjustified by market and economic fundamentals[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 appreciation 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 made 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, the narrower bands could be reimposed (as they might be, for example, for the pre-in Member States during stage three of EMU). One of the countries forced out in 1992, Italy, subsequently rejoined the ERM in November 1996 after long negotiations with other Member States and new members have subsequently joined. Austria joined on entry to the EU and Finland joined in October 1996. Furthermore, all Member States have ratified the Maastricht Treaty 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 former UK Prime Minister, John Major, who said in a celebrated article in the *Economist* that:

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4 Source: Commission Economic Papers Number 108, July 1994, p45

5 IMF, *World Economic Outlook,* October 1993

> I hope my fellow heads of government will resist the temptation to recite the mantra of full economic and monetary union as if nothing had changed. If they do recite it, it will have all the quaintness of a rain dance and about the same potency.[6]

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 economic recession that affected Europe in the mid-1990s 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 that 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 that has to bear the cost. However, it is not necessarily the currency at the lower end of the range that 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 that 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 then German Finance Minister, Herr Genscher, responded with his own memorandum, 'A European Currency Area and a European Central Bank'. It stated that a

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6 *Economist,* 25 September 1993

7 Quoted in Gros & Thygesen, op cit p313

single currency and a central bank would be catalysts to achieve the necessary convergence of economic policies of Member States without which monetary union could not exist. Events proceeded quickly and 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.

D. The Delors Report[8]

The Delors report listed three necessary conditions for a monetary union:

- the total convertibility of currencies
- the complete liberalization of capital flows and full integration of financial markets, and
- the irrevocable locking of exchange rates.

Delors accepted that the third of these conditions did not necessarily entail a single currency, however, its adoption:

> Might be seen – for economic as well as psychological and political reasons – as a natural and desirable further development of the monetary union. A single currency would clearly demonstrate the irreversibility of the…. union, considerably facilitate the monetary management of the Community and avoid the transaction costs of converting currencies…The replacement of national currencies by a single currency should therefore take place as soon as possible after the locking of parities[9]

The consequence of this move was freely admitted:

> This shift from national monetary policies to a single monetary policy is an inescapable consequence of monetary union and constitutes one of the principle institutional changes[10]

The Delors Report also commented on the need for co-ordinated fiscal policies of those Member States that were part of the monetary union. Speaking in terms that would find echoes later in the formation of the Growth & Stability Pact, the Committee noted:

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8 The Report on Economic and Monetary Union in the European Community, 12 April 1989

9 Op cit pp23

10 op cit pp24

> In particular, uncoordinated and divergent national budgetary policies would undermine monetary stability and generate imbalances in the real and financial sectors of the Community. Moreover, the fact that the centrally managed Community budget is likely to remain a very small part of total public sector spending and that much of this budget will not be available for cyclical adjustments will mean that the task of setting a Community wide fiscal policy stance will have to be performed through the co-ordination of national budgetary policies.[11]

Later, the Committee recommended that:

> In the budgetary field, binding rules are required that would: firstly, impose effective upper limits on budget deficits of individual member countries of the Community, although…..the situation of each member country might have to be taken into consideration; secondly, exclude access to direct central bank credit and other forms of monetary financing while, however, permitting open market operations in government securities; thirdly, limit recourse to external borrowing in non-Community currencies.[12]

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.[13] On the basis of the Report, the Commission staff prepared proposals for EMU that eventually became the Maastricht Treaty.

III. The 'Maastricht' treaty[14]

A. Introduction

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[11] Op cit pp30

[12] Op cit pp30

[13] HC Deb 29 June 1989 c.1107

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

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 that 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:

> 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".[15] 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".[16] Article 104c (2) and its relevant Protocol define excessive deficits in the following two ways:

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

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

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

If a Member State looks to be in danger of failing to meet the criteria there then follows a long drawn-out procedure of ever-increasing severity. The Commission prepares a report on the Member State involved. A Monetary Committee,[17] 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

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[15] article 104 c (1)

[16] article 109 e (4)

[17] article 109 c (1)

to take specified measures to remedy the situation.[18] 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;
> - 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.[19] 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 that will assume such importance in Stages 2 and 3.

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[18] article 104c (9)

[19] article 73 b

C. Institutional developments

1. Stage 2

i. Monetary Committee

One role for the Monetary Committee has already been mentioned - the monitoring of Member States' budgetary performance. In addition it can deliver opinions to the Council or Commission on its own initiative or at their request and, at least once a year, it will look at the position regarding the freedom of movement of capital between 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.[20]

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 that 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 governing the collection, compilation and distribution of statistics in the areas within its field of competence;

[20] article 109c (1)

- 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.[21]

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".[22] The ESCB will be composed of the ECB and the central banks of the Member States.[23] It shall be governed by the decision-making bodies of the ECB[24] 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;
> - to contribute to the smooth conduct of policies relating to the prudential supervision of credit institutions and the stability of the financial system.[25]

ii. European Central Bank [ECB]

The independent[26] 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[27]

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[21] article 109 f (2 & 3)
[22] article 105 (1)
[23] article 106 (1)
[24] article 106 (3)
[25] article 105 (2 & 3)
[26] article 107

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 authorise the issue of bank notes[28] 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.[29]

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".[30]

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".[31]

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

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;

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[27]article 109 (2)

[28]article 105 (a)

[29]article 105 (a) (2)

[30]article 108 (1)

[31]article 109e (1)

- 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 that 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.[32]

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**".[33] 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.[34] 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".[35]

2. Stage 3

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[32] article 109j (3)
[33] article 109j (4)
[34] *Financial Times* 7 April 1997
[35] article 109 k (2)

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 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.[36]

The diagram on the following page attempts to portray the sequence of events and the changing institutional and policy arrangements that have applied and will apply from the Treaty date until the process is fundamentally completed in 2002.

[36] article 109 l (4)

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.[37] 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.[38]

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

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

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.

Papers on related subjects have been:

97/76	Inflation: the Value of the Pound 1750-1996	06.06.97
96/32	Economic Indicators: July 1997	01.07.97
97/44	Economic & Monetary Union	09.04.97
97/36	The European politics of EMU: Developments in Germany, France, Italy and Spain.	20.03.97
97/83	The Amsterdam Treaty	25.06.97