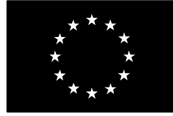
EUROPEAN PARLIAMENT



Directorate-General for Research

WORKING PAPER

EMU:

RELATIONS BETWEEN "INS" AND "OUTS"

Economic Affairs Series
ECON-106 EN

This publication will be available in EN

A summary will be available in all the Community languages.

Publisher: European Parliament
L-2929 Luxembourg

AUTHOR: Michael Lloyd

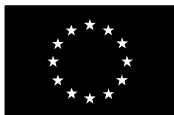
EDITOR: Ben Patterson
Directorate General for Research
Economic Affairs Division
Tel.: (00352)4300-24114
Fax: (00352)4300-27721
E-Mail: GPATTERSON
Internet: gpatterson@europarl.eu.int

The opinions expressed is this working paper are those of the author and do not necessarily reflect the position of the European Parliament.

Reproduction and translation of this publications are authorised, except for commercial purposes, provided that the source is acknowledged and that the publisher is informed in advance and supplied with a copy.

Manuscript completed in December 1998.

EUROPEAN PARLIAMENT



Directorate-General for Research

WORKING PAPER

EMU:

RELATIONS BETWEEN "INS" AND "OUTS"

Economic Affairs Series

ECON 106 EN

10/98

CONTENTS

I SUMMARY i

I. Introduction i
II. What the Treaty Says i
III. The Stability and Growth Pact i
IV. Institutional Aspects ii
V. Problems and Prospects ii
VI. Monetary Stability and Exchange Rate Stability ii
VII. Challenge for the 'Ins' iii
VIII. Challenge for the 'Outs' iii
IX International Representation Implications iv
X. Which Way Forward? iv

1 INTRODUCTION 1

1.1 The Outline Scenario 1
1.2 EMU for the 'Ins' 2
1.3 EMU for the 'Outs' 3

2 WHAT THE TREATY SAYS 7

2.1 General Interpretation 7
2.2 Treaty Articles which Do Not Apply to the 'Outs' 7
2.3 Treaty Articles which Do Apply to the 'Outs' 7
2.4 Summary Position on Treaty 8

3 THE STABILITY AND GROWTH PACT 9

3.1 General Interpretation 9
3.2 The Pact in Summary 9
3.3 Motivation, Operation, and Practical Effects 11

4 INSTITUTIONAL ASPECTS 11

4.1 General 13
4.2 The ECB 14
4.3 The European Commission 15

4.4 EcoFin (and the Euro-11 Council) 15
4.5 European Parliament 16

5 PROBLEMS AND PROSPECTS 17

5.1 General 17
5.2 Problems for EMU 18
5.3 Prospects for EMU 20

6 MONETARY STABILITY AND EXCHANGE RATE STABILITY 21

6.1 Monetary Stability 21
6.2 Exchange Rate Stability 21

7 CHALLENGE FOR THE 'INS' 25

8 CHALLENGE FOR THE 'OUTS' 27

8.1 General 27
8.2 Denmark 28
8.3 Sweden 28
8.4 Greece 29
8.5 United Kingdom 29

9 INTERNATIONAL REPRESENTATION IMPLICATIONS 31

9.1 Implications for the 'Ins' and the 'Outs' 31

10 WHICH WAY FORWARD? 33

SUMMARY

I. Introduction

Eleven countries will enter the third stage of economic and monetary union on January 1, 1999. The challenge to those adopting the single currency and for those remaining outside, for the time being, will be three-fold.

For the Ins, it will, for the large countries, be a novel and, to an extent, a hazardous process during the first few years.

For the Outs, it remains to be seen if and how these Member States will develop any policy coherence of their own *vis-à-vis* the Ins, who will necessarily have an increasing degree of economic and monetary integration.

For both the Ins and the Outs the key unanswered question is: how EMU will work and be managed within the European Union as a whole? EMU will clearly be exposed to economic and monetary tensions because of having a number of Member States, particularly the UK as a large country, outside the single currency area.

II What the Treaty Says

It was clear at Maastricht in 1992 that provision for derogation from the third stage of EMU would have to be made. Indeed, the UK insisted on a formal, ex-ante derogation protocol for itself being written into the Treaty. However, it was not possible to frame the Treaty in such a manner as to take full account of a situation where some Member States were ’inside’ and others were ’outside’. The drafting difficulties in 1992 were exacerbated by the fact that it is not possible to ’pin down’ in legal form an on-going economic process, and that progress to the commencement of EMU was itself a ’staged’ process.

III The Stability and Growth Pact

The Stability and Growth Pact has certainly been interpreted - and indeed supported by the majority of governments whether of the Ins or the Outs - as being aimed at a continued reduction of deficits and public debt, and as constraining fiscal policy. There is little doubt that this was one intention of the Pact and certainly its portrayal in the media and in the markets. Moreover, it will - certainly for the time being - exert considerable fiscal discipline on the Ins - and, partly voluntarily, on the Outs. Indeed the Pact may be said to represent the current economic orthodoxy. Nonetheless, it should be noted that the Pact is not intended to be as restrictive in relation to fiscal policy as many believe.

IV Institutional Aspects

The institutional issues surrounding the management of an evolving economic and monetary union, with the majority of Member States being within stage three of EMU, and a significant minority remaining in stage two of EMU, are complex and likely to be contentious.

The ECB itself will also have a difficult task in establishing its credibility and independence in the early years of EMU with the added problem of its relations with the 'Out' countries via the General Council of the ESCB, on which will sit the Governors of the Central Banks of all *fifteen* Member States.

Yet perhaps the most difficult of institutional problems will occur at the level of EcoFin and less in relation to monetary policy itself than between economic policy and monetary policy at European level and the potential conflict between national economic policies which needs to be co-ordinated at European level. The creation of the, informal, Euro-11 Council will mean constant - if informal - tensions between the Ins and the Outs at this level.These tensions are likely to be reinforced by the permanent qualified majority which the Ins will have on EcoFin and all other Councils.

V Problems and Prospects

The prospects for the successful launch and the early successful development of economic and monetary union rest on whether or not - within broad limits - real economic convergence can be maintained between the Member States entering into the third stage of EMU. There is little doubt - as the UK in its Presidency role stressed - that *all* the countries of the European Union have a vested interest in the success of EMU, and not simply those joining in the first wave.

The prospects for a successful EMU for the Euroland countries seem good. The only problems seem to be those posed by the existence of a significant group of Out countries, particularly in reaction to the harmonious working of the Single Market. If many problems emerge, then it is likely that the Ins will discriminate against the Outs. This presents a genuine danger to the cohesion of the European Union. The only other factors threatening EMU would be ones arising within the global economy.

VI Monetary Stability and Exchange Rate Stability

Monetary stability may generally be interpreted as price stability. However, price stability cannot be ensured by monetary policy alone. Fiscal and wages policies are essential complements of monetary policy in attempting to achieve price stability, i.e. a sustained low rate of inflation. Exchange rate stability is, by definition, ensured for the eleven Ins. Greece

and Denmark are likely to maintain stable exchange rates with the euro by membership in ERM2, though these cannot be guaranteed. The UK and Sweden do not propose to join ERM2.
The exchange rate turbulence and devaluations which occurred during the 1990s has a damaging impact on growth and trade flows stability in the European Union. If this were repeated between the Outs and the Ins, then the development of the single market and the evolution of co-ordinated structural economic policies would be jeopardised. Moreover, there would be considerable political tensions generated if the value of the pound sterling, in particular, were to depreciate rapidly and substantially against the euro, or even if there were to be substantial volatility in the euro/pound sterling relationship, created by UK policy.

Finally, there is the problem that if the Outs do regard themselves as genuine Pre-Ins then unless they maintain a stable relationship between their currencies and the euro they will fail to meet the Maastricht conditions applying to all applicants to adopt the Single Currency. Moreover, the Ins may decide to call upon the procedures in the Treaty to create a set of rules, agreed with the Outs via EcoFin after consultation with the ECB, designed to ensure that the exchange rates of the Outs are managed in line with the 'common interest'.

VII Challenges for the Ins

The Ins are entering uncharted territory, with unknown monetary dynamics and the surrender of monetary policy to the independent ECB. In addition, the consequential co-ordination of economic policy is likely to be greater than that currently envisaged. The continuing business and economic integration of the economies of the European Union will be accelerated within Euroland and policies to 'manage' this integrated situation will need to be developed and political control exerted over them.

The attitude and policy relationship as of the Ins in relation to the Outs may develop into one where key economic decisions are likely to be taken by the Euro-11 'Council' and hence, it is possible, though not necessarily desirable, that the Outs will come to be regarded as 'outsiders'. The main challenge, therefore, for the Ins is to seek to avoid such a situation occurring, if possible.

VIII Challenges for the Outs

The Outs may feel relieved at not having to face the realities of the momentous step that has been taken by the majority adopting the single currency. However, this sense of relief may be short-lived and is probably also short-sighted. The Outs are likely to be faced, sooner rather than later with deciding whether they are genuinely Pre-Ins.

Greece, alone of the Outs, appears definitely to have made this decision. However, though the UK appears to be committed, in principle, to joining, so long as the date for joining is some

years away and not yet determined it will become increasingly difficult to 'shadow' the policies of Euroland sufficiently closely (or be accepted by the Euroland countries as being able to do so) to be a realistic Pre-In. Hence, the UK is likely to have to decide earlier than is usually anticipated, on adoption of the Single Currency.

Sweden and Denmark are thought likely to follow the UK; though given the close result on the Amsterdam Treaty referendum, whether there is a realistic prospect of the Danish electorate permitting its government to adopt the single currency is not at all clear.

IX International Representation Implications

The adoption of the euro by the Ins requires a clear view to be taken as to the representation ofthe Community, and particularly the euro-area countries, within the various international fora, e.g. IMF, G7, etc. This is not only required for monetary matters, where the ECB now must have a role, but also on economic and trade policy matters. Shortly before the end of 1998, the Vieena Summit took a decision on the issue; but this has not entirely clarified the situation, particularly in view of the unwillingness of the United States to accept increased European representation.

There are clear implications for the Outs and particularly for the UK, which is separately represented on a number of the key international fora and there may be divergence of views which would weaken the Community position in international discussions. However, it should not be impossible to reach a common view between the Outs and the Ins on the majority of occasions.

X Which Way Forward?

The way forward for both Ins and Outs would seem to be to avoid, as far as possible, divergence between the Ins and Outs, with the Outs deciding sooner rather than later to adopt the single currency. Precise economic convergence is not likely to be attained nor is it required to adopt the single currency. The essentials required are political will on the part of the Ins and the Outs; a commitment to further economic integration and parallel policy integration on economic and not simply monetary issues; and an acceptance that the Europe of economic and monetary union is a positive, and probably necessary, response to globalisation.

It is difficult to envisage a different scenario in the medium-term than a full-hearted commitment of all the Member States of the European Union to developing economic and monetary union as the mechanism for enabling the peoples and the countries of the European Union to control their economic destinies and provide the economic prosperity in terms of employment and income that the citizens of Europe desire.

1 INTRODUCTION

1.1 The Outline Scenario

Eleven countries were deemed eligible (under the interpretation of the Maastricht conditions) and were willing (discounting the formal 'opt-outs' negotiated by the UK and Denmark) to adopt the single currency on 1 January 1999. This has left four Member States - the UK, Denmark, Sweden, and Greece - outside the third stage of economic and monetary union.

The terms 'Ins' and 'Outs'[1] used in the title of this report are in a sense misleading. The situation is rather that the Ins are now within the third stage of EMU, leaving the 'Outs' effectively within the *second* stage - even though, strictly speaking, the second stage has ceased to exist. The non-participating countries simply have a derogation and should, therefore, be regarded as 'Pre-Ins', waiting to enter the third stage. The distinction is, therefore, one of degree rather than a rigid dichotomy between the positions. This is not to deny, however, that the differences will become greater and more difficult to manage as time goes by. Problems are likely to manifest themselves sooner rather than later.

Whether the non-participating countries, aside from the obvious and not unimportant fact of their being members of the European Union, may be said to form a coherent grouping, either politically or economically, appears doubtful. As indicated later in this paper, notwithstanding some similarities, particularly between the UK and Sweden, there are considerable differences, economic and political. Clearly, one factor pushing for a coherent approach is their situation as 'excluded' (whether voluntarily or by failure to meet the convergence criteria) members of the third stage of economic and monetary union; and hence from the further integration which will necessarily be pursued by the 11 countries which have adopted the euro.

However, whether or not they act as a coherent grouping, their relations, and particularly that of the UK as the largest 'Out' country, with the countries entering into the third phase of economic and monetary union will be crucial. This will be so whether we consider the position of Ins or that of the Outs, either individually or as a loosely linked group. Economic and monetary union was never going to be easy for the European Union. The fact that a number of countries are likely to be outside for a period of some years represents a further set of difficulties. It is these potential problems which are the main subject of this paper.

From the viewpoint of the Outs, had there been only a small majority of countries adopting the euro then it would have been in one sense an easier situation to manage. The balance of power would have been in their favour had the Euro-area (Euroland) comprised two large countries - say Germany and France - together with a few of the smaller countries. However, the final outcome means that the Outs are clearly the 'outsiders', with the Ins having the substantial economic weight, and the political balance thus favouring them.

---

[1] Henceforth, for convenience 'Ins', 'Outs' and 'Pre-Ins' will be referred to as Ins, Outs and Pre-Ins.

Hence, for both the Ins and the Outs the key unanswered question is: how EMU will work and be managed within the European Community as a whole? EMU will clearly be exposed to economic and monetary tensions because of having a number of Member States, particularly the UK as a large country, outside the single currency area. Equally, those countries outside EMU will be impacted by EMU and the associated economic and monetary policies. These issues will be particularly acute in relation to exchange rate relationships, with the Pound sterling\Euro rate of special significance. There will also be impacts on decision-making within the European Union, as the establishment of the 'Euro-11 Council' indicates.

1.2 EMU for the Ins

It is doubtful if there is a full recognition, particularly among the larger Member States, of what will be entailed in the commitment to economic and monetary union. This 'partial myopia' has been exacerbated by the unbalanced focus on monetary union rather than on the *economic* and monetary union envisaged by the Maastricht Treaty and, more specifically, the Delors Report; though this has been partly redressed by the Employment Chapter of the Amsterdam Treaty. The concentration on the achievement of the Maastricht convergence criteria, and the establishment of the ECB, has so far concealed the need for substantial economic policy co-ordination at the European level.

In his 2 December 1997 Council of Ministers' report to the Economic and Monetary Affairs and Industrial Policy Committee (EMAC) of the European Parliament, President in Office of the Council Juncker forcefully made the point that only Luxembourg and Belgium had any experience of running an economic and monetary union and the degree of extra solidarity and partnership in economic decision-making which was entailed. It is a point worth re-emphasising because of the relative ease of the relationship between Belgium, with a GDP of 211 billion ecu and Luxembourg with a GDP of 14.1 billion ecu, compared to the considerably more complex relationship required between the eleven entrants to third stage EMU.

It should be noted that what is immediately created by the establishment of third stage EMU is a single currency; a single monetary policy; and a single exchange rate policy, with price stability given primacy in relation both to the single monetary policy and to the exchange rate policy. From 1 January 1999 (and indeed effectively before then, from May 1998) an irrevocable link has been created between each of the existing national currencies of the participants in EMU. Hence there can be no national exchange rate policies. It is also clear that the intention is that monetary policy will have primacy within EMU and, therefore, there will be no exchange rate target policy. In any event, the nature of the Euro-area as a substantially closed economy means that domestic monetary policy considerations will inevitably take priority over exchange rate policy, except in the case of a serious and sustained misalignment. For some participants in EMU this may be hard to swallow. The Ins, as a group, meanwhile, will have economic policy managed via, principally, monetary

policy. Any attempts to utilise other policies, eg fiscal policies, in 'opposition' to the direction of the single monetary policy will be subject to multi-lateral surveillance and the strictures of the Growth and Stability Pact.[2]

However, on the other hand, it does not seem to be fully acknowledged that the Ins are likely to insist on the exchange rate policies of the Outs being managed as policies of 'common interest', as the Treaty states. This will certainly be the case if the Outs are properly to be regarded as Pre-Ins. If this policy imperative is interpreted literally and rigidly it implies that the monetary policies of the Outs will have to accommodate exchange rate targets based on stable relationships with the euro. This would entail the Outs not having independent monetary policies of their own.

1.3 EMU for the Outs

The key problem for the Outs is whether they do genuinely consider themselves in a transitional phase before entering the third stage of economic and monetary union. This is more a matter of political attitude than the achievement of sustainable economic convergence, though the latter is clearly important, as the above points on exchange rate policies make clear and as is discussed later in this paper.

Of the four Outs only Greece appears fully committed to entry once it has achieved monetary convergence based on the Maastricht criteria. For others, it appears to be more of a lack of political will to enter rather than an inability to meet the convergence criteria, though the UK has advanced as one of the primary reasons for delay a lack of 'sustainable convergence'. This concept is not, apparently, congruent with the Maastricht convergence criteria - which the UK would mostly appear to meet - and appears also to be capable of varying interpretation. However, politically the UK government is committed in principle to joining, and active preparations are being made to ensure that business, in particular, is ready for entry. The five 'tests' last done by the UK government should be 'unambiguously' met. How this is to be decided was not made clear in the UK Treasury document (see Box A).

[2] If, in fact, as presumably intended by the Maastricht Treaty, it becomes possible to achieve zero budget balance about which the surplus/deficit can fluctuate from an unlimited surplus to a minus 3% deficit, it would provide some reasonable degree of freedom for fiscal policy.However, this may turn out to be a counsel of perfection.In any event it does not invalidate the point that the fiscal and other economic policies of the Ins must be consistent with monetary policy.

BOX A: UK SINGLE CURRENCY TESTS

The Chancellor of the Exchequer has set out five economic tests which have to be met before Britain enters:

- Are business cycles and economic structures compatible so that we and others could live comfortably with euro interest rates on a permanent basis?
- If problems emerge is there sufficient flexibility to deal with them?
- Would joining EMU create better conditions for firms making long-term decisions to invest in Britain?
- What impact would entry into EMU have on the competitive position of the UK's financial services industry, particularly the City's wholesale markets?
- In summary, will joining EMU promote higher growth, stability and a lasting increase in jobs?

Assuming, however, that all of the Outs are to be regarded as 'in transition' before entry at some time during the next 4/5 years, then how is this likely to impact on their economic policies and their relations with the Ins? As this is the subject of this paper, at this point all that may be observed is that preparation for entry would appear to require that the following conditions be met:

- Stability of exchange rates in line with the Maastricht criteria.
- Achievement and maintenance of fiscal/budgetary discipline in line with the Maastricht criteria.
- Achievement and maintenance of internal price stability in line with the Maastricht criteria.

The problems for the Outs may, however, be more serious than indicated by these 'conditions'. In essence, the Outs will have not only to maintain or achieve the Maastricht conditions, but will have to do so during a transitional period when autonomous, further

business integration will take place within Euroland and when also economic policy co-ordination between the Ins will deepen considerably.

For the Outs it will be a major task to ensure that their *business sectors* are not disadvantaged in competitive terms and are able to handle the parallel currency implications of the existence of the euro as the currency of the majority of the European Union single market.

Equally important will be a recognition that the Outs will inevitably be excluded from *economic policy deepening* by the Ins; whatever may be the formal position of the EcoFin Council.

From a *political viewpoint* it may be argued that a period observing the success of the euro from outside may persuade the population of the Outs to become more positive towards the euro. However, it may equally be argued that to remain outside, without too many disadvantages being *perceived* by the general public, may incline public opinion to swing against accepting the single currency.

2 WHAT THE TREATY SAYS

2.1 General Interpretation

Although it was made clear by the UK during the establishment of the Maastricht Treaty in 1992 that certain Member States would require to exercise derogations, notwithstanding the meeting of the convergence criteria laid down in the Treaty, the position regarding the treatment of these Member States with a derogation is not entirely clear.

This is not, perhaps, surprising. Apart from not being able to forecast, at the time of Maastricht, which countries would meet the convergence criteria and, in the case of the UK, and subsequently Denmark, which would also be willing to adopt the single currency, the implementation of the various economic and monetary policies within the EMU, let alone the impacts on those outside EMU, could not then be fully foreseen.

What is apparent is that some Treaty articles will not apply to the Outs, while others will still apply, when the Ins enter the third stage of EMU. However, even here the situation is not entirely clear. Hence it is not possible to provide an exhaustive definition of coverage. Essentially, however, the relevant articles do fall broadly into two groups:

a) Those which , according to the Treaty, do not apply to the Outs

b) Those which , according to the Treaty, will still apply to the Outs

2.2 Treaty Articles which Do Not Apply to the Outs

These article are the following:

Articles 3a(2); 104c(1), (9), (11); 105(1) to (5); 105a; 107; 108; 109; 109a1 and (2)(b); 109I(4) and 5)

The non-applicability of these articles means, essentially, that the Outs retain their powers in the field of monetary policy and exchange rate policy according to national law.

2.3 Treaty Articles which Do Apply to the Outs

These articles are the following:

Articles 109(c); 109(e); 109(i); 109(j); 109(k); 109(m); 109(n); 109(o); 109(p); 109(q); 109(r); 109(s)

The applicability of these articles means that as far as possible the Outs shall be constrained to be subject to policies of common interest, save only for those allowing them rights to control monetary policy and exchange policy.

2.4 Summary Position on Treaty

Clearly, the Treaty position is important and is treated as such by all participants at the European and at national levels. However, it should be noted that frequently it is the spirit of the Treaty which is interpreted rather than the strict letter of the law. In essence, the Treaty is likely to be used - in relation to the operation of economic and monetary policies between the Ins and the Outs - as a reference framework. The aim will be to minimise any conflicts between the Outs and the Ins. How far this will be possible, given economic realities, is questionable. Moreover, the danger, if serious conflicts do arise, is that differing interpretations of the Treaty will be advanced. Eventually these can be resolved via the European Court. However, this is a long, and, in this context, not a fruitful approach. It is likely, therefore, that any disputes relating to the operation of Treaty articles affecting the Outs and the Ins will be resolved politically rather than legally.

3 THE STABILITY AND GROWTH PACT

3.1 General Interpretation

The inspiration for the Stability and Growth Pact came very much from the Germans, with the emphasis placed firmly on the stability aspects. The French, on the other hand, though not objecting to stability per se did not wish the 'regime' imposed to inhibit growth, and also believed that the Pact should be 'interpreted' using political judgement.

The Pact has certainly been interpreted - and indeed supported by the majority of governments whether of the Ins or the Outs - as aimed at a continued reduction of deficits and public debt, and as constraining fiscal policy. There is little doubt that this was the intention of the Pact and certainly its portrayal in the media and in the markets. Moreover, it will - certainly for the time being - exert a considerable fiscal discipline on the Ins and also partly voluntarily, on the Outs. Indeed the Pact may be said to represent the current economic orthodoxy .

Nonetheless, it should be noted that the Pact is not intended to be as restrictive in relation to fiscal policy as many believe. What is aimed at is the achievement of budget balance. Once this has been achieved - and some countries have already achieved this situation - then a considerable amount of cyclical flexibility is permitted, ie around the budget balance. In addition, if there is severe asymmetric shock affecting one country then that country can, as far as is necessary, increase its deficit beyond the 3%.

Hence, as one of the criticisms of the Maastricht Treaty was that it did not provide for any contra-cyclical action on government budgets, the Stability and Growth Pact may be seen as rectifying that omission. Based on a *balanced budget situation* there will be room for a Member State to operate prudent fiscal manoeuvrability

The Stability and Growth Pact has,therefore, been a development of the Maastricht criteria on the budgetary/government financial position of Member States. The intention is to enforce tight discipline on budgetary policy, attempting to ensure movement towards balance across the economic cycle. It also attempts to achieve tight coordination of all non-monetary economic policies between Member States, both to those inside the single currency and, to a lesser extent, to those outside. It remains to be seen how effective this attempt at discipline and co-ordination will be. It seems likely to lead to some political tensions between the European institutions. It may also lead to an inadequate economic coordination, particularly if Member States attempt to negotiate 'deals' behind closed doors. However, problems in this respect in practice (see below) may not be serious.

3.2 The Pact in Summary

The **intention** of the Pact is to define more specifically the excessive deficit procedure set out in the Maastricht Treaty. The effect will probably be, during the transition period before budget balance across the economic cycle is achieved, to tighten budgetary policy with some associated costs. However, once a zero or minimal structural deficit is achieved then the effect will be to provide considerable flexibility in deficit financing across the cycle where considered essential or necessary. For some countries the intention also is to apply the 'golden rule', ie to borrow only for public investment purposes and not to fund public consumption.

The Pact will operate via two Council Regulations which were further defined in the Weigel Plan in May 1998, which developed the earlier Council Resolution on the Pact. In essence these regulations will:

- strengthen the surveillance and co-ordination of budgetary positions
- speed up and clarify the implementation of the excessive deficit procedure.

The **first** of these Regulations will ensure that Member States (Ins) will have to present 3-year, rolling 'stability programmes' (Outs will continue to present similar 'convergence programmes'). The stability and convergence regimes will contain:

- an objective and an adjustment path for budget surpluses/deficits and forecasts of the government debt ratio;
- the main official forecasts for growth, unemployment, inflation, and other important economic variables;
- a description of the budgetary measures being taken;
- a clear commitment to take additional measures, when necessary, to prevent slippage from the set targets.

The first stability and (continued) convergence programmes have now been submitted. Subsequent programmes would be updated annually and submitted not later than two months after the presentation of annual budget proposals by a Member State to its national parliament.

The EcoFin Council will then have two months to consider the programmes and, if necessary, recommend adjustments. The initial examination will be done by the Economic and Financial Committee of senior civil servants and central bankers.

The second Regulation makes precise the deadlines for the excessive deficit procedures and the penalties attached,

- ♦ EcoFin will have **three months** following the submission of Budget figures by a Member State to decide whether an excessive deficit exists and recommend the actions to be taken by the Member State concerned

- ♦ EcoFin will then have a further **four weeks** to decide to make its recommendation public if effective action has not been taken by the Member State.

- ♦ EcoFin then have a further **two months** to decide whether or not to impose sanctions.

The penalties initially involve payment of a non-interest bearing deposit from the Member State. The deposit will include a fixed sum of 0.2% of GDP for every percentage point above the 3% deficit reference level. There will be an upper limit of 0.5% of GDP and if the excess deficit was due to non-compliance with the government debt criteria only the fixed sum will be levied. If the deficit is still in existence **two years** later then the initial deposit will become a non-refundable fine and a new non-interest bearing deposit will be issued.

3.3 Motivation, Operation, and Practical Effects

On initial examination the Pact seems harsh, both in its motivation and in its political impact; though clearly more severe on the Ins than the Outs. However, there are two aspects which should be borne in mind when evaluating the likely impact of the Pact, and a third aspect relating to relations between the Ins and the Outs.

Notwithstanding the above formal, legal position it seems highly unlikely that such severe, and to some extent counter-productive, penalties will be exacted. More importantly will be the desire of member states to avoid the embarrassment of finding themselves in the position of being judged by their peers. Moreover, there is the possibility of derogation from the procedure if the excess deficit is exceptional and temporarily resulting from an unusual event (an asymmetric shock) outside the control of the Member States.

The operation of the Pact is likely to act as an effective budgetary discipline both for the Ins, who are potentially subject to the above harsh penalties for non-compliance, and the Outs who must attempt to avoid such deficits (but who will not be subject to the penalties of the Pact). The 'stability' and 'convergence' programmes which the Ins and the Outs, respectively, have to produce, are related to their national budget formulation each year.These will provide the mechanisms for ensuring that excessive deficits do not occur, save for exceptional events.

Hence, despite some appearances to the contrary it is unlikely that the Stability and Growth Pact will create tensions between the Ins and the Outs. Indeed, the adherence of the Outs to the Pact, via their convergence programmes, is more likely to significantly reduce the likelihood of potential problems than to create difficulties.

4 INSTITUTIONAL ASPECTS

4.1 General

The roles of the various European-level institutions in relation to economic and monetary union are both complex and contentious.The fact that 11 countries have adopted the single currency means, because of the qualified majority voting procedures, that the eleven Ins have a permanent majority, when voting together, in the EcoFin Council (See 4.4 below). Moreover, in the context of monetary policy, the European Parliament, as the only directly-elected European-level institution, may lay claim to a key role in terms of holding democratically to account the independent and unelected European Central Bank, which will be responsible for the common monetary policy of the Euro-area, and whose influence will, by this fact, and its operational roles, impact on all aspects of economic policy, affecting all Member States of the European Union.

The suggestion of a new, powerful, role for the European Parliament in relation to monetary policy, notwithstanding the clear, if limited, powers given to the European Parliament by the Treaties, is likely to be resisted by most Member States' governments. The issue will, of course, be resolved in the course of time, and it seems certain that, whatever the views of governments, the European Parliament will have a crucial role in influencing the European economic debate within which the ECB and the ESCB will have to formulate and implement monetary policy.

In relation to economic policies, e.g. the formulation of the Broad Economic Guidelines, Ecofin may attempt to minimise the European Parliament's influence (and, for that matter, the European Commission's) on economic policy co-ordination. This is likely to become a contentious issue for the management of EMU. There is also the issue of the role of National Parliaments of both Ins and Outs in influencing the policies of individual Member States, and whether some co-ordination of views can take place at European level.

The institutional issue relating to the powers of the European Parliament is more complex than appears at first sight. The fact that the European Parliament, has, in some areas, the power of co-decision with the Council of Ministers - though not in relation to Economic and Monetary Union issues where it has limited powers under the co-operation procedure - means that it is not simply a legislature in the manner of Parliaments in most European Union member states. The European constitution has some similarities with the US constitution in this respect. EcoFin will not, however, wish to cede powers to the Parliament in this most contentious area of policy.

Hence, though the European Parliament may in the future be granted more powers in specific instances (for example, the power to veto appointments to the European Central Bank Executive Board) its influence on economic and monetary policies under EMU will be confined to informal influence. Though more powers could be granted to the Parliament, to go beyond a strengthened ability to be able objectively to criticise the monetary policy of the

ECB, and the economic policy co-ordination of EcoFin, might be to compromise the essential independence of the Parliament in exercising its democratic accountability role.

The European Parliament's role in relation to the central monetary policy developed by the ECB and the ESCB will be matched by the roles of the national parliaments of the European Union Member States - whether Ins or Outs - in holding their own governments and central banks (at least in the Outs) to account. It will probably be appropriate, therefore, for consultation to take place between the relevant committees of the European Parliament and the national parliaments to exchange information and views on policy coordination issues.

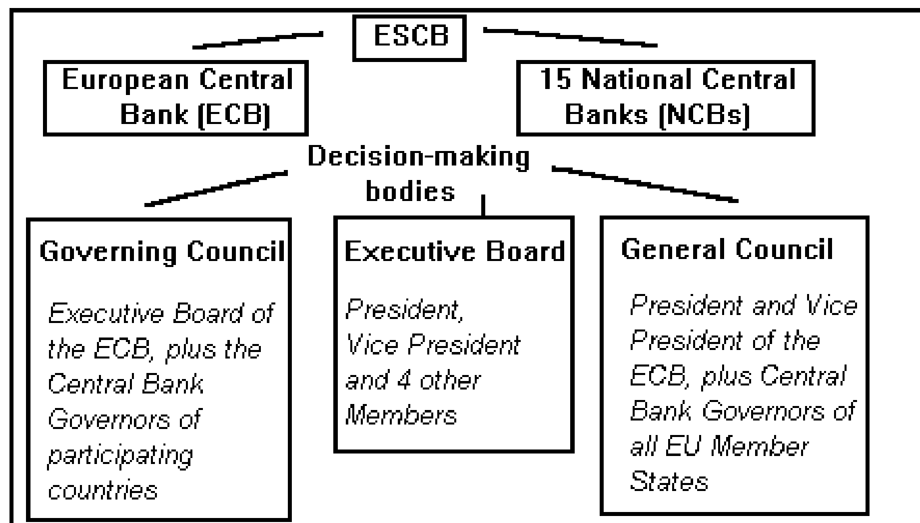
In relation to the institutional developments linked to the evolution of EMU it may be reasonable to expect future Treaty amendments to ensure an appropriate balance of institutional powers. Such an eventuality may be preceded, however, by an inter-institutional agreement on co-operation procedures.

4.2 The ECB

The ECB as a new 'federal' institution, responsible for developing within the European System of Central Banks (ESCB) the monetary policy for the Euroland countries, will have the added task of attempting to avoid any substantial inconsistency between the monetary policies of the Ins and the Outs.

In institutional terms this should be possible because of the constitutional links between the central banks of the Ins and of the Outs and the ECB. The position is that the ECB President and Vice-President have seats on the Governing Council of the ESCB, representing the eleven Euroland countries' central banks, and the ECB President is also President of the General Council of the ESCB, representing all fifteen countries in the European Union. However, the untested institutional mechanisms may not in themselves, in practice, prevent inconsistent policies from developing. It is likely that political accommodations will have to be reached (see Figure 1)

Figure 1: The European System of Central Banks



Such political accommodations may, of course, be seen as interfering with the independence of the ECB. Providing independence is not viewed rigidly (after all central banks do not operate in a vacuum) such accommodation should not be seen as a threat to the ECB's independent role.

4.3 The European Commission

The European Commission's role remains crucial to the development of EMU and to 'bridging the gap' between the Ins and the Outs. The Commission will formulate policy on a European level basis, ie the Europe of the 15 Member States. It will be interesting to see how the relationship develops between the Commission and the ECB. The Commission will no longer have any direct role in recommending monetary policy to Member States, but it will retain this role in relation to economic policies, at both macro- and micro- levels. It seems likely that in its future activity it may align itself with the European Parliament as a means of challenging the influence of EcoFin. It will, of course, have the principal responsibility for recommending or not the acceptance of any application by an Out country to join the Single Currency, judged against the Maastricht criteria.

4.4 EcoFin (and the Euro-11 Council)

The most difficult institutional issues are likely to arise in the context of EcoFin. Not only is EcoFin charged with the responsibility for multilateral surveillance of economic policies and the operation of the Stability and Growth Pact, but it must also work closely with the other institutions, ie the Commission, the Parliament, and the new, powerful ECB and ESCB. To assist in this process there are three committees linked to the Council: the Economic and Financial Committee (formerly the Monetary Committee), the Economic Policy Committee, and the Employment Committee. The Economic and Financial Committee will be comprised of Member States' officials and a larger number of central banks' representatives, and will clearly have the role of ensuring consistency between the decentralised economic policies of the Member States and, for the 11 Euroland countries, the single, central monetary policy.

However, it should be noted that if they vote as a bloc then the Ins will have a permanent majority on the EcoFin Council, and indeed on all Councils.The Euroland countries will hold 66 of the 87 (weighted) votes, providing an automatic qualified majority. In institutional terms then, as well as in economic influence, the Ins will outweigh the Outs.

Hence, a powerful influence on relations between the Ins and the Outs at EcoFin Council will be the, informal, Euro-11 Council. It is insisted that all decisions on economic policy, multi-lateral

surveillance, and the Stability and Growth Pact will be taken within EcoFin, as the only legally constitutional body under the Treaty to have the necessary powers. Notwithstanding this insistence, and the formal, legal position of EcoFin, in practice the Euro-11 Council is likely to take decisions on economic integration which will be specific to the Euroland countries. Whether or not EcoFin formally endorses these decisions - and , because of the qualified majority situation, it would have little difficulty in endorsing them - there is likely to be a differential impact on the Ins and the Outs.

4.5 European Parliament

The European Parliament has specific, but limited, roles given to it by the Treaty. Essentially these provide for the relevant Committee of the Parliament to invite Executive Board members of the European Central Bank, and particularly, the President to appear before it, and to have the Annual Report of the ECB presented formally to the Committee.

However, the Parliament is seeking to enlarge its sphere of influence, not only in relation to the ECB (while respecting the independence of the ECB as guaranteed by the treaty), but also its relation to the areas of economic policy governed by EcoFin, eg the annual Broad Economic Guidelines.

One important characteristic of the European Parliament is that by definition, its work is not affected by the division into Ins and Outs. Indeed, in general, the Parliament operates on a high degree of consensus achievable across political groups, without dividing on national grounds, though from time to time national divisions do emerge. It is possible, therefore, that the European Parliament - aside from a growing influence and credibility in a European institutional and policy context - may also provide a forum(built also on its developing dialogue with National Parliaments) in which accommodations between the Ins and the Outs can be arrived at. Nonetheless, there is a limit to what may be achieved in this respect as the analysis of this paper indicates.

5 PROBLEMS AND PROSPECTS

5.1 General

The prospects for the successful launch and the early successful development of economic and monetary union rest on whether or not - within broad limits - real economic convergence can be maintained between the Member States entering into the third stage of EMU. There is little doubt - as the UK in its Presidency role stressed - that *all* the countries of the European Union have a vested interest in the success of EMU, and not simply those joining in the first wave.

However, while monetary convergence can only be sustained in the longer term by parallel convergence in the real economy, it is also the case that monetary conditions should be such as to permit an investment-led economic growth scenario to develop. If the ECB decides to pursue a rigid and tough line on inflation - aiming at near zero inflation - it is doubtful if such a policy will establish monetary conditions conducive to investment-led economic growth. If a tight deflationary monetary policy is instituted, then government deficits are likely to increase and debt reduction will become more difficult. Moreover, a further deflationary period could prevent employment from growing and the social tensions arising from unemployment, already severe in some countries, would be exacerbated.

It is frequently asserted that the virtuous economic cycle desired includes: reducing government deficits; falling public debt levels; low inflation; sustained economic growth; and reducing unemployment. However, the key issue is how an economy *enters* the virtuous cycle. This must be through the stimulation of growth. Fiscal restraint, of itself, cannot produce economic growth; nor can low inflation, though conventional orthodoxy argues it is a pre-condition for growth. Nonetheless, stability of market economic variables is essential if for no other reason than it will permit low interest rates and other factors to maintain investment-led growth.

In the European Community low inflation/price stability has been achieved. The 1998 figure is likely to be around 1.6%; a historically low figure. The growth required can only come from three main sources on the demand side; consumption, net exports, and investment. Consumption-led growth could lead to inflationary pressures. Further net export-led growth is unlikely, given the relatively closed nature of the European economy and its already substantial balance of trade surplus. This leaves investment-led growth as the principal route into the virtuous cycle. Moreover, sustainable growth will be essential to achieve the economic and social cohesion required within Euroland.

To achieve the requisite increase in investment will require monetary conditions to be relaxed rather than tight. With the low inflation referred to above, the timing could not be better for the initial setting of such monetary conditions, and the operation of a single monetary policy to facilitate the substantial increase in investment required. Such a policy will, on the one hand, give the confidence (as in the US) for European entrepreneurs to invest and, on the other hand, for sustained growth to produce and permit the reductions in deficits and public debts via fiscal policies aimed at achieving budget balance over time. It will also enable Member States to cope

with any asymmetric shocks which may occur in the future, though these are likely to be regional rather than national, at least in the large countries.

What happens in the Euroland of the eleven in respect of the success of EMU will obviously also affect the economic position of the Outs. As Pre-Ins, if that is to be their situation, it would be not only preferable, but necessary for the Outs to follow similar macro-economic policies.

A key issue remains, though, at the level of *micro-economic*, structural policies and the impact of these on both Ins and Outs and on the cohesion of the single market. Again this issue is related to the temporary or permanent nature of the Outs position on the adoption of the Euro. Though there has been discussion of variable geometry as a political mechanism for a multi-speed Europe, it is difficult to see how this can work as between those adopting the Single Currency and those not. This will be, *inter alia*, a further problem for enlargement of the European Union.

5.2 Problems for EMU

The main problem in the early years of EMU is, essentially, whether or not - within broad limits - *real* economic convergence can be achieved and maintained between the Member States adopting the Single Currency.

The distinction made here is between *monetary* convergence, covering principally price stability, exchange rate stability**,** and the convergent low, long-term interest rates, and *economic* convergence, covering variables such as economic growth and employment, including their balanced spatial distribution. The meeting of the Maastricht convergence conditions ensured that the 11 countries adopting the euro have achieved monetary convergence. The Maastricht *budgetary* conditions did set variables which, while clearly having an impact on the real economy, are nonetheless essentially 'mechanistic', in that they simply set parameters to which the real economy must adjust.

The key issue, therefore, is whether the autonomous pressures in the real economy and the evolution of wages, investment, consumption, and the balance between private and public sectors can be sufficiently 'guided' to ensure the maximum correspondence between the monetary economy and the real economy. Partly this will depend on whether monetary policy, fiscal policy, and wages policy can be set to ensure an appropriate macro-economic framework to enable sustained, non-inflationary, and spatially balanced, investment-led economic and employment growth.

If the ECB were to decide to pursue a rigid and tough line on inflation - aiming at near zero inflation - it is doubtful if such a policy will establish monetary conditions conducive to investment-led economic and employment growth. If a tight deflationary policy were to be adopted then clearly unemployment would be exacerbated. Moreover, investment would be inhibited and economic growth would slow.

However, given the movement out of recession of the German and French economies and the current existence of price stability it seems unlikely that - at least for the first year or so - ECB monetary policy will be tightened. However, there is a danger that 'loose' fiscal policies followed by the Member States could prejudice the inflation objective of EMU, not withstanding the Stability and Growth Pact, and would lead to unnecessarily high interest rates, thus reducing growth.

A further danger is that though overall economic growth may be positive, regional differences could be increased. Should this happen, it is argued that lack of labour mobility across Europe and the lack of downward flexibility in nominal wages will lead to worsening regional disparities as asymmetric shocks affect regional growth. It is further argued that the situation could not be remedied by fiscal transfers as the European Union budget is substantially inadequate for this purpose, compared to the US or to Germany, as examples of federal systems.

Were these points to be accepted in their entirety then the regional patterns which might arise within EMU might indeed seriously threaten the whole EMU project. However, all of the issues raised here are subject to qualification.

- First, most of the arguments are based on optimal currency area theory, some aspects of which are challengeable.
- Second, geographical labour mobility is only one type of labour mobility; occupational and sectoral mobility are also important and easier to achieve. Moreover, labour mobility in the US compared with Europe is not as high - in a counter-cyclical sense - as is sometimes suggested.
- Third, the need for nominal wage flexibility can be exaggerated; real wage flexibility, via regional price differentials, is more likely to occur and to provide an adjustment mechanism.
- Fourth, the actual use of federal funds required for counter-cyclical compensation is not as large as is often suggested. In addition, under EMU national fiscal flexibility, in regional terms, is not only possible, but likely.
- Fifth, asymmetric shocks are less likely in the EU because there is less specialization of industry than, say, in the US. Finally, the European structural funds, *provided* they are adequately funded and targeted, can have a positive impact on regional economic development and the capacity to absorb shocks.[3]

Given the above, fears of substantial, or even significant, exacerbation of existing regional disparities within Euroland as a *direct* result of the single currency seem premature and unlikely; though the possibility cannot be discounted entirely.

[3] This issue is dealt with fully in "Adjustment to asymmetric Shocks" *Economic Affairs Series*, ECON 109 EN, European Parliament, September 1998

Perhaps the main problem for EMU related to the existence of the Outs and the Ins, therefore, is likely to be the dangers for the efficient and progressive operation of the Single Market posed by the existence of a significant minority of the economy of the European Union remaining, for the time being, outside the third stage of EMU.

5.3 Prospects for EMU

The prospects for EMU seem to be positive. The conjunctural economic situation, particularly in Germany, France, and Italy, seems favourable in relation to investment-led growth. There is no indication so far from the ECB that anything other than a relaxed monetary policy will be followed for the time being. So far there is no hard evidence that Euroland countries will relax their fiscal policies to a degree which might prejudice the price stability objective. The euro seems likely to be a strong currency, *vis-à-vis* the US dollar and the Japanese yen, and this is not likely to lead to inflationary pressures inside Euroland.

Taking these factors into account the prospects for a successful EMU for the Euroland countries seem good. Again whether these prospects will materialise depends partly on the threats posed by the existence of a significant group of Outs to the harmonious working of the Single Market. It seems likely that if problems did emerge which appeared to threaten the prospects of a successful EMU for the Ins then the Ins would be likely to discriminate against the Outs. Such an outcome would threaten the cohesion of the European Union. The only other factor which would harm the prospects for EMU are global factors (eg the Asian crisis) over which Euroland will gradually be able to exert more influence as the Euro becomes a global currency and as the international institutional influence of the ECB becomes greater.

6 MONETARY STABILITY AND EXCHANGE RATE STABILITY

6.1 Monetary Stability

Monetary stability may generally be interpreted as price stability. However, price stability cannot be ensured by monetary policy alone. Fiscal and wages policies are essential complements of monetary policy in attempting to achieve price stability, i.e. a sustained low rate of inflation. (Some monetary economist may disagree with the proposition that policies other than monetary policy are necessary to curb inflation; but they would be a minority).

In so far as inflation in Euroland is maintained at the current approximately 1.6%, price stability and monetary stability may be said to have been attained. Hence, interest rates and monetary policies can be targeted on the achievement of investment-led, economic growth. Monetary policy will work via relative asset price changes, direct effects on consumer demand, and by stimulating buoyant entrepreneurial expectations.

The danger is that the degree of convergence on price stability, monetary policy conditions, and investment-led growth in the Euro-area may not be shared by the Outs. (NB In the case of the UK this seems particularly likely, without policy measures to ameliorate current structural, and to a lesser extent, cyclical divergencies).

6.2 Exchange Rate Stability

Exchange rate stability is, by definition, ensured for the eleven Ins. Greece and Denmark are likely to maintain stable exchange rates with the euro through their participation in ERM2, though this cannot be guaranteed. The UK and Sweden on the other hand are likely to see considerable exchange rate movements between their currencies and the euro (See box B).

Exchange rate stability between the euro and non-European currencies, primarily the US dollar and the Japanese yen, is not likely to be sought by any formal or even informal exchange rate mechanisms. Euroland, the US, and Japan are all relatively closed economies which can afford to have policies of 'benign neglect' as far as their currencies are concerned. Their currencies are likely to be allowed to float, on the assumption that over time their rates against each other will reflect the relative economic fundamentals of the three trading blocs. (Whether this will be the case at times of global monetary turbulence is an open question; capital account forces are very strong and the massive excess of global liquidity, well beyond that needed to finance trade flows, could produce substantial and arbitrary exchange rate movements from time to time).

Of more immediate and local concern will be the exchange rate relationship between the euro and those European Union currencies lying outside the single currency, particularly the pound sterling. The relationship between the pound sterling and the euro will be of particular concern to Ireland whose trade flows with the UK are substantial. This will be true, though a lesser extent, for the exchange rate between the Swedish kronen and the euro for Finland. There is

likely, at least for a period, to be an unstable relationship between the pound sterling and the euro. Partly this will be due to domestic economic circumstances within the UK and sterling's traditional volatility and partly because of the pound sterling being a 'hedging' currency outside the euro.

The exchange rate turbulence and devaluations which occurred during the 1990s had a damaging impact on growth and trade flows stability in the European Union. If this were repeated between the Outs and the Ins, then the development of the single market and the evolution of co-ordinated structural economic policies would be jeopardised. Moreover, there would be considerable political tensions generated if the value of the pound sterling, in particular, were to depreciate rapidly and substantially against the euro, or even if there were to be substantial volatility in the euro - pound sterling relationship attributed to UK policy.

The problem for the Ins and the Outs is, therefore, whether the four Outs have a desire to maintain a stable exchange rate relationship with the euro, and indeed whether even if they wish such a stable relationship - in line with managing their exchange rate policies in the 'common interest' - they will be able to maintain it. Speculative pressures against the pound sterling, even if not related to the 'fundamentals' of the UK economy, would result in considerable volatility being exhibited between the pound sterling and the euro.

If an Out country did attempt to fix its exchange rate then its monetary policy would have to be operated so as to accommodate the maintenance of the target rate of exchange. This is particularly the case in an open economy such as the UK. Ideally, the Outs will want to have both a discretionary monetary policy and a stable exchange rate against the Euro. They will not be able - except fortuitously - to have both. The UK creates a particular problem, because of its size; because of its history of exchange rate volatility, and because its current exchange rate is held by many observers to be too high.

Finally, there is the problem that if the Outs do regard themselves as genuine Pre-Ins then unless they maintain a stable relationship between their currencies and the euro they will fail to meet the Maastricht conditions applying to all applicants to adopt the Single Currency. Moreover, the Ins may decide to call upon the procedures in the Treaty to create a set of rules, agreed with the Outs via EcoFin after consultation with the ECB, designed to ensure that the exchange rates of the Outs are managed in line with the 'common interest'.

BOX B: CONVENTIONS AND PROCEDURES FOR THE NEW EXCHANGE RATE MECHANISM (ERM2)

♦ Participation in the exchange rate mechanism will be voluntary for all non-euro area Member States. A Member State which does not participate in the exchange rate mechanism from the outset may participate at a later date. The operating procedures for the new exchange rate mechanism have been laid down in an agreement between the European Central Bank (ECB) and the non-euro area national central banks.

♦ For the currency of each Member State participating in the mechanism, a central rate against the euro and a standard fluctuation band of ±15% will be defined, in principle supported by automatic unlimited intervention at the margins, with very short-term financing available. However, the ECB and the participating non-euro area national central banks could suspend automatic intervention if this were to conflict with their primary objective of maintaining price stability. In line with the Resolution of the European Council, exchange rate policy co-operation may be further strengthened, for example by allowing closer exchange rate links between the euro and other currencies in the exchange rate mechanism, where, and to the extent that, these are appropriate in the light of progress towards convergence.

♦ For all the currencies of the non-euro area Member States participating in ERM2, the exchange rate for the bilateral central rate vis-à-vis the euro will be quoted using the euro as the "base" currency. This means that for all currencies the exchange rate will be expressed as the value of 1 using six significant digits. The same convention will be applied for quoting the upper and lower intervention rates vis-à-vis the euro of the currencies of the non-euro area Member States participating in ERM2. The intervention rates will be determined by adding or subtracting the agreed bandwidth, expressed as a percentage, to or from the bilateral central rates. The resulting rates will have to be rounded to six significant digits;

♦ In order to reduce the settlement risk inherent in unlimited intervention at the margins, a payment after payment procedure will be applied as from 1 January 1999 by both the ECB and the euro area national central banks and may be applied by the non-euro area national central banks participating in ERM2. However, the payment after payment procedure to be applied is intended as a temporary solution for the interim period between the entry into force of ERM2 and the introduction of a reliable payment versus payment mechanism covering the euro and other ERM2 currencies.

7 CHALLENGES FOR THE INS

The Ins are entering uncharted territory, with unknown monetary dynamics and the surrender of monetary policy to the independent ECB. In addition, the consequential co-ordination of economic policy is likely to be greater than that currently envisaged. The Member States' concerns at the initial prescriptive nature of the Commission's recommendation for the Broad Economic Guidelines, within the multi-lateral surveillance framework, indicates the sensitivity of Member States. However, this nationalistic response must give way to an acceptance that economic policy co-ordination must emulate the centralised monetary policy developed by the ECB and the ESCB.

The advent of the euro will have the effect of speeding up the process of business and economic integration. This will occur as an autonomous process, promoted by price transparency; the absence of exchange risk; lower transaction costs, and the accompanying competitive forces. There will, therefore, be a need to manage this process via appropriate supportive national and European-level policies.

The development of relevant policies at macro-economic and micro-economic, structural levels will require the use of qualified majority voting on these issues. Whether there is the political will yet developed to accept the procedure required for the economic reform agenda is not clear. Nonetheless, a gradual development of co-ordinated/centralised economic policies will take place. Policy measures which affect the working of the single market, eg some taxation issues, competition policy measures, etc, will have a differential impact on the Out countries and the Ins. In effect the deepening of integration will be greater among the Ins than the Outs. This may, of course, tend to encourage the Outs to use their exchange rates as a mechanism for redressing the balance. If this happens then the Outs may well retaliate and in any event such a move would create tensions between the Ins and the Outs.

Because of the desire and, indeed, necessity of the Ins to maximise the benefits of adopting the single currency by supporting the development of business integration and bypursuing considerable economic policy co-ordination to maintain consistency with the single monetary policy conflicts are inevitably going to arise between the Ins and the Outs. There is a danger that the really important decisions on policy co-ordination will be taken by the Euro-11 Council. The key issue, therefore, is how the Ins can manage this process without the Outs becoming to be regarded as 'outsiders'. Such an outcome would clearly not be desirable.

8 CHALLENGES FOR THE OUTS

8.1 General

The Outs may be relieved at not having to face the realities of the momentous step represented by the adoption of the euro. However, the situation for the Outs may, in fact, be even more problematic[1].

We should first examine the common problems that the Outs will face and then look briefly at the positions of the four individual countries.

As has been argued for the Ins, to avoid severe problems for economic and monetary union (or even its collapse/implosion; though no serious commentator expects this to happen) will require considerable economic policy co-ordination. Only in this manner will it be possible to produce an integrated economic policy to match the single monetary (and single exchange rate) policy under economic and monetary union. However, this will, almost inevitably, imply - whatever may be stated as the formal political position - the gradual exclusion of the Outs from the 'deepening' of the economic, monetary, and trade policies of Euroland. Hence, the Outs are likely to be faced with a clear decision - in the short-term rather than the medium-term - as to whether they are genuinely Pre-Ins.

One dimension of this problem will be realised in relation to the intensification of the Single Market process or, as some have, appropriately, termed it, the creation of a genuine home market. Formally, the Single Market covers all of the Member States of the European Union. However, it is clear - and autonomous business economic processes and economic policy co-ordination will confirm the situation - that the Single Market between the Ins will be capable of a greater degree of integration than that of the Euro-15, and this greater integration will gradually take place.

A further dimension of the problems for the Outs relates to taxation issues. While there is no great enthusiasm for harmonisation there is broad agreement on the need to eliminate harmful tax competition and to avoid extreme differences between the levels of taxation imposed on particular commodities or segments of the economy. This agreement is likely to produce pressure, particularly within the 11 countries of Euroland, to co-ordinate tax bases and, to a lesser extent, tax rates, e.g. setting minima and/or maxima. Hence, although unanimity is required to achieve agreement on taxation issues for the European Union as a whole, there would appear to be no reason why, informally, the Euroland Member States could not make individual changes to their tax systems which simply happen to co-incide. The effect of such a move, though benefiting the Euroland countries, would be likely to distort competition between the Outs and the Ins. (NB Such action be challenged by the Outs in the European Community, but such an outcome would merely serve to exemplify the tensions).

[4] One of the points missed by those in the Out countries who argue for those countries remaining outside the single currency area is that the advent and likely evolution of Euroland alter very substantially the economic and trading environment for any European Union country intending to opt out of the euro-zone.

The principal policy problem for the Outs may well be their policy towards fixing or otherwise their exchange rates against the euro. If they are to fix their exchange rates against the euro - as Greece and Denmark have indicated - then, *effectively* their monetary policy will be that pursued by the ECB. If they do not fix their rates then they will be able to operate an independent monetary policy - as the UK and Sweden intend. However, fluctuating rates will, inevitably, create tensions between Euroland and the Out countries involved, and distort the Single Market. (It will be recalled that the Outs are obliged by the Treaty to regard their exchange rates against the euro as matters of 'common interest'). Hence, if the Outs are to become Pre-Ins, then at some point - earlier rather than later - their exchange rates will have, at a minimum, to 'shadow' the euro, or more likely, be formally fixed against the euro by joining the ERM2. Such exchange rate stability even if judged ex-post would have to have existed for around two years in order to meet the Maastricht criteria. For the Outs, deciding, ex-ante, when this period will commence is likely to prove problematic, particularly as it has political as well as economic implications.

8.2 Denmark

Denmark is the one Out country which - next to Belgium/Luxembourg - is perhaps the most integrated into the European Union. As a small, open trading country some 68.5% of its trade is intra-European. For this reason, though political support among the populace in Denmark for economic and monetary union is weak, in economic terms the case for Denmark adopting the Single Currency appears strong. For this reason the Danish decision to peg the crown against the euro is prudent, almost essential. Indeed, it might be argued that to all intents and purposes Denmark will be, by 'default', the 12th Euroland country.

8.3 Sweden

The position of Sweden and the UK has a particular symmetry. The UK has a major, smaller trading partner, Ireland, which is an 'In' country. Sweden has a similar position *vis-à-vis* Finland as the 'In' country. In both cases, if there is a high degree of volatility between the rate of the pound sterling and the Swedish crowns against the euro, then this will adversely affect trade between the UK and Ireland and Sweden and Finland; producing both economic and political tensions. Sweden has similar structural divergence problems to that of the UK (see below) and also has similar adverse public opinion.Hence,many if not all of the points applying to the UK will apply to Sweden.

8.4 Greece

Greece has decided to 'peg' the drachma to the euro and hence, providing the fundamentals of the Greek economy do not change adversely, there should be few problems as the Greeks have committed themselves to continue their convergence programmes aimed at meeting the Maastricht criteria. Providing these programmes are adhered to there should not be a problem for the exchange rate between the drachma and the euro, and markets will re-inforce the exchange rate stability and the convergence of Greek long-term rates to those of Euroland.

8.5 United Kingdom

The UK has produced specific economic reasons why it could not adopt the single currency from 1.1.1999. In essence the reasons reduce to a combination of cyclical divergence and structural divergence between the UK economy and the other European economies, specifically the German and French economies, as opposed to the US economy. In particular, this means that severe problems could be created by the fact that the current level of interest rates prevailing in Euroland, around 3.5%, is less than half that of the UK, whose sensitivity to interest rate changes is greater than for instance Germany.However it is not clear that all these reasons are as strong as is sometimes supposed.

The lack of *business cyclical convergence* is misleading if cited as a reason why the UK is unable to join the single currency.There are four points to be made:

♦ Lack of *cyclical* correspondence (measured by capacity/output gap), in so far as it is a problem, will still be a problem for the UK whether inside or outside the single currency area, given the preponderance of UK trade with the rest of the European Union

♦ The lack of cyclical convergence may be regarded as a positive factor rather than a negative one. Within a currency union not only will it be unlikely that national business cycles will have perfect correlations, but some degree of non-synchronization is likely to be beneficial, to avoid all parts of the currency union either inflating or deflating together.

♦ The are three reasons for the cyclical divergence during the late - 1980s to the present:

  - the financial services deregulation which took place during the mid to late 1980s in the UK;
  - the tightening of the German monetary stance because of the way the re-unification of Germany took place;
  - the sheer depth of the recession in the UK in the late 1980s, coupled with the rapidity of the upswing.

However, these factors have diminished over time and, providing government policies do not recreate further divergence, the UK economy may be expected gradually to move back into synchronisation with the German and French economies,as indeed they were during the 1970s and the early 1980s.

- The use of business cycle synchronization statistics may also be more generally criticised, as may more specifically the use of Germany as the main comparator for the UK. Hence:
  - any comparison depends for its validity on the existence of *genuine* business cycles during or over the periods selected; that there is a high degree of arbitrariness in such a procedure is obvious;
  - upturns and downturns in economic activity are principally caused by the policy responses to the initial autonomous shocks;
  - the variation in synchronization over relatively short historical periods reduces severely any deterministic value in the correlations produced;
  - policy changes can substantially influence synchronization, in either direction;
  - different variables, eg output gaps, gdp, industrial production, produce different correlations;
  - Germany is the least correlated European country with the UK, its weight within a UK/Euroland comparison will be reduced
  - insofar as it is suggested that the UK is more closely correlated with the US than with Germany then some explanation should be offered as to why such a situation should exist;
  - it is also the case that correlations between various other countries are equally difficult to explain, casting doubt on what may well be spurious statistical relationships, not unknown in economics, and/or, as indicated above, strongly influenced by policy action.

However, it may be observed - and here the examination concerns principally the UK - that there *is* a lack of *structural* convergence between the UK and the Euroland countries (NB In fact the position of Sweden in respect of structural divergence is somewhat similar to that of the UK).

There are two *main* areas of structural mismatch:

- the very short-term, variable-rate financing of SMEs in the UK;
- the large amount of housing mortgage debt in the UK, again financed on a variable interest rate basis.

Neither of these historical situations can be maintained if the UK is to be characterised as Pre-In. Both situations are undesirable, representing serious areas of instability in an economy seeking stability as a primary goal. Both are capable of being reformed, and hence reduced in severity,

by policy means. Such policy action would seem desirable both in its own right and as preparation for entry into the single currency.

9 INTERNATIONAL REPRESENTATION IMPLICATIONS

The introduction of the euro will mean that there will be a corresponding monetary presence to complement the economic and commercial weight of the European Community in the global economy. It will clearly be necessary, therefore, to establish effective and efficient Community representation on monetary, economic, and exchange rate policies at international level, in the various international bodies. This needs to be done as provided for in Article 109(4) of the Treaty in compliance with the allocation of powers laid down in Articles 103 and 105.

The current division of the Community into the Ins and the Outs adds a further dimension to ensuring the effective, efficient, and equitable representation at international level.

The Vienna Summit held at the end of 1998 decided that the Community would be represented at international level by the Council *with* the Commission; and by the ECB. The Council would be represented by the President in Office of the Council, *providing the Member State in question had adopted the euro as its currency*. Where the current President was from a Member State which had not adopted the euro (i.e. an Out) then it wouldl be the next In Member State which will assume the representational role.

Where the rules of particular international organisations did not permit the immediate (and full) implementation of the procedures for common representation at international level, the institutions of the Community would implement temporary arrangements matching as closely as possible the 'ideal' form of representation.It would be the responsibility of the Member State holding, or assumed to be holding, the position of President in Council to ensure that Member State representatives (there may, of course, be other European Community Member States involved, eg in the IMF) and Community representatives fully coordinate with one another to ensure a single Community view is expressed.

Finally, as regards the preparation of the work by the Council, the Economic and Financial Committee would assist in the preparation of all Community positions on the basis of a proposal *or other suggestions* from the Commission.

This decision, however, is not the final word. In particular, the United States has been unwilling to accept the increased European presence in international bodies to which implementation would lead. This, in turn, has prompted certain Euroland countries *not* at present represented directly - for example, all except France, Italy and Germany in the case of G7 - to reopen the issue.

9.1 Implications for the 'Ins' and the 'Outs'

It is, therefore, not yet clear how external representation will work in practice. Some Member States have taken the view that the Commission - and for that matter the ECB - should play only minor roles at international level, sufficient only to meet a *strict* interpretation of the respective roles assigned to the Commission and the ECB in the Treaty. If the decision is implemented in

this way, then it will undoubtedly weaken the European Community - and particularly those smaller Member States who have adopted the euro. Not to have a common Community position when discussing monetary and economic issues matters in the various international fora is also likely to be damaging to the overall interests of the Community.

However, though this case is relatively straight forward as far as the Ins are concerned, it is less clear how far the Outs will be able to go along with the establishment of common positions. In certain situations the provision *may* imply a weakening of the individual position of an Out country in expressing their views in the international organisation.

Again this will apply principally, almost solely, to the UK as the largest Out and as the one most established in key positions in a variety of international fora. Disparities in the positions of the UK as an Out and the Ins is likely most obviously to manifest itself where the relationship of the US dollar to the euro is involved. Over the past six years the sterling rate appears to have been more closely linked to the US dollar than to the D Mark; though it is by no means clear why this is so, and in earlier years it was not the case.

However, notwithstanding the potential problems arising from the formal positions of the UK and the Community as such, there are ample reasons why in the majority of cases the same view may be taken by the UK as by the Community.

10 WHICH WAY FORWARD?

With the possibility of derogation being incorporated in the Maastricht Treaty came the possibility of a problematic relationship between those countries moving into the third stage of economic and monetary union and those, temporarily, waiting to enter. The adoption of the single currency was an option to be exercised by all member states of the European Union. Insufficient consideration was given at the time of Maastricht - not surprisingly - to problems which might occur if derogations were temporary and *long*, or even that they might be permanent. Hence, though there are provisions in the Treaty which ostensibly appear to cover relations between those adopting the single currency by January 1, 1999 and those who might be unable to do so by that date, they are, in reality, based on the assumption that any derogations will be for a short period only.

This paper has attempted to prove that tensions, economic and political, between the Ins and Outs are almost certain to emerge - ironically because of the large number of countries deemed to have met the Maastricht criteria and, therefore, adopting the single currency - sooner rather than later. The longer the period before the Out countries adopt the single currency the more severe the tensions are likely to be. This may, for these countries preferring to delay for some years, have the effect of advancing their time-table for entry.

Some resolution of the political difficulties likely to emerge between the Ins and the Outs is urgent, not only because it threatens the cohesion of the current European Union, but also because the proposed enlargement will bring in new, less-developed economies. These countries for more fundamental economic reasons, are unlikely to meet the Maastricht convergence criteria for some years to come. There might then emerge an unwelcome three-tier European Union.

What is required to move forward to resolve these issues - aside from considerable flexibility and good-will between the Ins and the Outs - would appear to be the following:

- a complete and rigorous economic analysis by the UK, as the largest Out country, of the convergence/divergence issue, and the introduction of policies to ameliorate dysfunctional structural divergence patterns of behaviour;
- a similar exercise should be conducted by Sweden, which in certain respects has similar structural divergence behaviour patterns to the UK;
- a consideration by Denmark of how far it is 'informally' part of Euroland and what economic dangers there are in not adopting the euro;
- a re-iteration of Greece's economic commitment to meeting the Maastricht convergence criteria;
- a substantial commitment of the Ins to ensure that, as far as possible without jeopardising their own need to deepen business and economic policy integration, the problems of greater economic dissonance between Euroland and the Out countries are minimised.

Whether these broad prescriptions can be accepted by those involved and whether they are able to create a situation where *sufficient* economic convergence can be attained - together with popular political acceptance - to enable the Outs to become Ins are key questions. What is becoming clear is that the future of the European Union and beyond that the ability of Europe to respond to the challenges of globalisation are substantially dependent on *all* the countries of the European Union, as envisaged by the Maastricht, entering the third stage of economic and monetary union.