POLITICS OF THE EUROPEAN MONETARY UNION (EMU) AND THE MAASTRICHT

Dissertation submitted to Jawaharlal Nehru University in partial fulfilment of the requirements for the award of the degree of

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To my Uncle

Sri C.N. Trivedi

who left us forever while this work was in progress

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CERTIFICATE

This is to certify that the dissertation entitled **"POLITICS OF THE EUROPEAN MONETARY UNION (EMU) AND THE MAASTRICHT"** submitted by **SANJEEV KUMAR TRIVEDI** in partial fulfilment of the requirements for the award of the degree of **MASTER OF PHILOSOPHY** of this University has not been previously submitted for any degree of this or any other university. This is his original work.

We recommend that this dissertation be placed before the examiners for evaluation.

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SANJEEV KUMAR TRIVEDI

PREFACE

When Robert Schuman, the former French foreign minister, proposed the pooling of the coal and steel resources of France and West Germany soon after the Second World War, little would he have realized that he was laying the cornerstone of one of the most momentous events in the global economy. But like the legendry Tautalus, one thing that has eluded Europe for over three decades is the idea of an Economic and Monetary Union. Consequently, 1 January 1999, the day Europe officially switches over to a single currency acquires a special significance. As we move towards the end of the millennium, the million dollar question is whether the proposed event could finally be put off?

The currency turbulence which engulfed the Exchange Rate Mechanism in 1992 reopened the debate on the working of the Mechanism and the broader issues of European Monetary Union. The Maastricht Treaty no longer bears a final word on the European single currency, nor does it indicate the steps required to achieve that goal. Rather the citizens across Europe are being asked to judge the merits of the Maastricht Treaty and decide what value they put on a common currency? But the three-stage approach to the EMU laid out in the Maastricht treaty appears to be more flexible than its detractors would have us believe and the approach remains clearly valid especially on the "convergence criteria" which are based on economic common sense and governments would be wise to follow them whether they envisage a single currency or not.

But what remains to be seen is whether the beginning of the 21st century will see an economic superpower of unprecedented dimensions emerging or will the European nations once again agree to disagree? The present work is an attempt to analyse the countdown of Europe's tryst with destiny and also a modest attempt to analyse implications of the burgeoning developments over the years and their intent and capability to meet the challenges of the on-going fast changing international economic dynamics.

Chapter I deals with the deepening of the already existing European Community, with the first election to the European parliament by universal suffrage in 1979 and the establishment, in 1979, of the European Monetary System (EMS) designed to create stable exchange rate among the currencies of the Member States.

Chapter Ii examines the working of the exchange rate mechanism uptil the establishment of the European Single Market, of which the main aim was to prepare the ground for economic and monetary integration.

Chapter III analyses the Treaty on European Union concluded in Maastricht on 7 February 1992; its three stage approach to the EMU, and the crisis that afflicted the ERM in 1992.

Chapter IV provides on insight on the outlook for the common currency and the objectives which the EC intends to attain while carving out path towards monetary integration.

And the last Chapter V comprises the conclusions. It explains the final attempts and also touches on controversial debate on the convergence criteria with regard to the EMU and the common currency, particularly in the light of the latest political changes in Britain and France.

Attempts to draw general conclusion or to make predictions about the future of the EMU solely on the basis of this work may not be concrete for the future shape of the EU depends only in part on its internal changing institutional dynamics. Apropos, noteworthy is the fact that previous phases of the EC institution building has been in response to the changes occurring both at the global and the European levels. What is happening now in Europe is also a component of a very uncertain process of global economic and political metamorphoses.

Chapter I

INCEPTION OF THE EUROPEAN MONETARY SYSTEM (EMS), 1979 - ITS OPERATIONS

Introduction

From among all the high GNP and developed regions of the world, Europe is unique. In cultural and historical terms, it is extraordinarily heterogenous, comprising as many as fifty major nationalities and nearly as many major languages. European economic development has, therefore, proceeded in the face of, and as a constant challenge to, a whole range of cultural and linguistic barriers. It is a tribute to the strength of the developmental impetus, as well as to the small size of the typical European state and the comparative inadequacy of Europe in raw materials, that the economies of the continent characteristically require trade in a much higher proportion of their GNP than the countries of any other comparable region.

As it is, the European Community (EC) has embarked upon a path inexorably leading to the eventful replacement of member countries currency through the European Monetary System (EMS) which was finally put into operation on 13 March 1979. The precise nature and length of the transaction period to Europe's monetary unification have yet to be determined while agreement on the political and economic structures required for the Community's monetary union to be durable is unlikely to be reached before the end of the century. Be that as it may, there now exists a political consensus in favour of complete monetary integration of the European Community (EC).

Monetary Union: Towards A Definition[1]

A group of countries may be perceived to constitute a monetary union if they experience identical rates of interest. Monetary union describes a set of monetary characteristics which implicitly involves the "as if assumption" that there exists a single currency throughout the Union. It follows, therefore that a monetary union is compatible with member countries retaining their national currencies provided the following conditions are satisfied:

a) there are no restrictions on the movement of capital across the Union.

b) Member countries' financial sectors are perfectly integrated.

One thing which is remarkable is that if national currencies are not replaced by a single union currency and the "as if assumption" is met, then the intra union exchange rates will be fixed even if they were not *de jure* fixed.

Motivations

In 1978 the European Community members agreed to establish the European monetary system (EMS) and with the exception of the UK, announced exchange rate parities. Against the background of violently fluctuating exchange rates during the previous five years and the failure of earlier attempts to establish Common Currency or even to limit intra-European exchange rate fluctuations, this enterprise aroused considerable scepticism. That this goal would inevitably entail making a political union

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[1] George Zis, "European Monetary Union: The case for complete monetary integration in *The Single European Market* (London: Pinter), 1989, pp.39-40.

into a federal or at least confederal, European member states had to face considerable opposition from important minorities, as well as enthusiasm from a great majority of public opinion in the EC as a whole.

The European Monetary System (EMS) however was able to rally unanimity from nationalists as well as from impatient Europeans for two reasons.[2] The first was the obvious collapse of the international monetary system and abdication of the previous determination to negotiate the reforms indispensable to its survival. The second was the general disenchantment with the "managed" or rather "mismanaged" floating rate system that had taken the place of the BrettonWoods Treaty. Contrary to the hopes of some of its promoters, this system did not arrest the inflationary flooding of international monetary reserves. It was this growing disenchantment with the system which served as first motivation of the European Monetary System (EMS) to which most members of the EEC could agree.

Background Setting

Academic discussion of European monetary integration predates Treaty of Rome, but for over a decade, discussion remained largely academic. As long as the European currencies were pegged to the dollar, the Treaty's recommendation that exchange rate fluctuations should be regarded as a matter of common interest was of no practical importance. The turmoil in foreign exchange markets of the late 1960s

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2 Robert Triffin, "The European Monetary System", in *Integration and Unequal development* (Florence: Allan Knot), 1991, p.223.

was perceived by European Community member countries as placing in jeopardy the success achieved in establishing a customs union and the common agricultural policy. It was believed that facility of exchange rates was necessary for the consolidation and development of these achievements.

The vision of a European economic and monetary union (EMU) with a single currency first appeared on the European Union's system horizon as early as 1969, when a summit of the then six member states set the goal of achieving European monetary Union (ENU) by 1980. This objective sketched out in the 1970 Werner Report[3] was reaffirmed in 1972 when the summiteers (now joined by Denmark, Ireland and the UK) committed themselves to converting their entire relationship into a European Union" by the end of the decade. However the ambitious project foundered in the economic tempest of the mid - 1970s.

A second attempt was made in the spring of 1972, after the Smithsonean Agreement had raised hopes of a more durable international monetary system (EMS) in the form of a package which included wider margins of fluctuation around the dollar. The European plan was to maintain a "snake" of narrower intra-European margins through the Smithsonean 'tunnel'. As prospective European Community (EC) members, the UK and Ireland joined the 'Snake' but were forced by the Sterling crisis

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[3] Completed in six months by a study group led by Pierre Werner, Prime Minister of Luxembourg the report called for a three stage transition with a progressive convergence of economic policies cultiminating in the irrevocable locking of exchange rates and adoption of a single currency.

to leave within a matter of weeks. Italy and France suffered the same humiliation at later dates, leaving Germany and Benelux as the only stable members of the Snake.

The failed attempts to secure closer monetary integration provided inauspicious background to the impassioned plea by the President of the European Community (EC) Roy Jenkins in 1978 for a reassessment of the case for European monetary union and of the means by which it might be achieved. The outcome of the ensuing political process, in which the French President and the German chancellor played a pioneering role, was the successful functioning of the European monetary system (EMS), in Denmark 1978 as "a zone of monetary stability in Europe". It feared a European currency unit (ECU) based on a basket of national currencies, plus an exchange rate mechanism (ERM) to minimise frictions between them.

First, Monetary stability bears two dimensions[4] a price and an exchange rate dimension and secondly, stability does not imply fixity or constancy; Stability in this context is measured by the predictability of inflation and exchange rates. That is, the European Monetary system was not envisaged as a system of fixed exchange rates. Instead its objective was to reduce exchange rate volatility and thus promote a greater degree of exchange rate predictability. Simultaneously, it aimed at the permanent reduction of inflation rates in the European Community (EC) as a means of promoting price predictability.

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[4] Ibid, p.42.

Objective

At its meeting held in Breanean on 6 and 7 July, 1978, the European Council comprising Heads of state and or Governments of the member states of the European Community (EC)[5], agreed on closer monetary cooperation among the member states. An outline of the system was made public as an annexure to the conclusions of the German presidency of the meeting. The main features of the European Monetary System (EMS) were set out in a resolution adopted by the European Council at its meeting in Brussels on 4 and 5 December, 1978.[6] The system went into operation as of 13 March, 1979 after difficulties relating to monetary aspects of the Common Agricultural Policy of the European Community had been resolved. At the same time, the European common margin arrangement (the "snake") ceased to exist.

The main objective of the European Monetary System (EMS) has been clearly stated by the European Council as a "zone of monetary stability" in Europe, paragraph 1.1 of the resolution of 5 December, 1978 and in the following quotation from the conclusion of the Presidency of the December 1978 meeting:

"The purpose of the European monetary system is to establish a greater measure of monetary stability in the Community. It should be seen as a fundamental component of a more comprehensive strategy aimed at lasting growth with stability,

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5. In 1978, the members of the European community were Belgium Denmark, France, Federal Republic of Germany, Ireland, Italy, Luxumberg, The Netherlands and the United Kingdom, Greece became a member on January 1, 1981.

6. Documents concerning the EMS published by the Commission of the European Communities in *European Economy* (Brussels), no.3 (July 1979).

a progressive return to full employment, the harmonization of living standards and the lessening of regional disparities in the Community. The European Monetary System (EMS) will facilitate convergence of economic development and give fresh impetus to the process of European Union (EU). The Council expects the European Monetary System to have a stabilizing effect on international economy and monetary relations".[7]

European Monetary System (EMS) Institutions and Practice

The primary institutional component of the European Monetary System is the exchange rate Mechanism (ERM). At the heart of the European monetary system (EMS) is a system of fixed but adjustable exchange rates. Each currency has a central rate expressed in terms of the European currency unit (ECU). These central rates determine a grid of bilateral central rates round which fluctuation margins of + 2.25 percent (6 percent for the Italian lira) have been established. But to keep within these margins, intervention by the participating central Banks is obligatory and unlimited in amount. Intervention is in principle to be effected in participating currencies. Intervention in other currencies (i.e. chiefly in US dollars) is also allowed and has been undertaken on a substantial scale.

The grid of bilateral central rates and intervention limits is supplemented by the "divergence indicator" which shows the movement of the exchange rate of each EMS currency against the (weighted) average movement of the other European monetary system (EMS) currencies. The criterion used in the divergence of the actual

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[7] *European Economy* (Brussels), no.3 (July 1979), p.94.

daily rate of the European Currencies Union (ECU)[8] central rate. If a currency crosses a "threshold of divergence" set at 75 percent of the maximum divergence spread, this leads to a presumption that the authorities concerned will correct the situation by adequate measures of domestic monetary policy, changes in central rates, or other measures of economic policy.

The European Currencies Union plays a central role in the European monetary system. It serves as the numeraire for the exchange rate mechanism as the denominator for operations in both the intervention and the credit mechanism, as a reference point for the divergence infraction, and as a means of settlement and a reserve asset of European Monetary System (EMS) Central Banks.

For financing of interventions in European Monetary system (EMS) currencies there are mutual credit lines between the participating central banks (the "very short-term financing facility"). Claims and debts arising from such intervention are settled according to certain rules governing, among other things, the use of economic currencies Union (ECU) for such purposes.

The "short-term monetary support" and the "medium-term financial assistance" which were established in 1970 and 1971, respectively, were substantially enlarged at the time of establishment of the European Monetary System (EMS). They now provide European currencies 25 billion of the effectively available credit, compared to 10 billion available before. The two facilities are available to all members of the European currency and are designed for mutual financial assistance in cases of balance

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8 1 ECU = US $ 0.97 on 30 December, 1982.

of payments difficulties thought they have not been used since the European monetary system entered into force.

At the start of the European monetary system (EMS), the central banks participating in the exchange rate mechanism of the european monetary system (EMS) received an initial support of ECU against "contribution" of 20 per cent of both their gold holdings and gross US dollar reserves (at market-related valuations) to the European monetary cooperation fund (EMS).[9] These transactions took the form of revolving three month swaps, which allow the necessary adjustments to keep contributions at the level of 20 per cent each of gold and US dollar reserves, and to take account of any price on fluctuations that may have occurred since the previous adjustment. It was argued that European monetary cooperation fund (EMCF)[10] would leave the administration of the reserves transferred to it by the swaps to the contributing central banks.

Under the provisions governing the European Monetary System (EMS) adjustments of central rates are "subject to mutual agreement by a common procedure which will comprise all countries participating in the exchange rate mechanism".[11]

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9 The United Kingdom, although not having participated in the exchange rate mechanism, in July 1979 decided to voluntarily contribute 20 per cent of its gold and US dollar reserves to the European Monetary Cooperation Fund (EMCF) against ECUs.

10 The EMCF was established as an institution of EC in April 1973, and has served as the administrator for transactions under the "snake" and the EMS as well as very short term financial facility and the short term monetary support.

11 Ibid, p.95.

But it goes without saying that the European Monetary System (EMS) functioning had its own share of problems and lacunas. At the intervention point two concerned central banks supply the stronger currency in exchange for the weaker one, but the process is not symmetrical. The central bank of the weaker currency loses reserves or accumulates external debts which must be repaid; its counterpart accumulates reserves which within much broader limits can be sterilised. This alleged deflationary bias was one of the British government's main objections to the European Monetary System (EMS) proposals.[12] Thus in an effort to meet it, a divergence indicator was established within the European Monetary System (EMS) with the aim of identifying the currency responsible for straining the system, and of creating a presumption as to which country should bear responsibility for corrective action. This divergence indicator is expressed in terms of the European Currencies Union (ECO) as a basis for comparing each currency's performance with the European Monetary System (EMS's) average. There is a presumption that action will be taken when the indicator reaches its "threshold" but corrective measures are not mandatory. Moreover, the indicator is subject to several technical limitations, including an asymmetry which makes it less likely, the larger its weight, that a currency will reach its threshold in the European currencies Union basket. In practice, furthermore, the intervention points are often reached before the divergence threshold, in cases where,

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12 Michael Sumner, "European monetary Integration", in David A. Dyker (ed.) *The European Economy* (England: Greenwhich), 1990, pp.139-14.

of two individual currencies, one appreciates while the other depreciates relative to others.

The operational ineffectuality of the divergence indicator is not the only evidence of asymmetry in the operation of the exchange rate mechanism (ERM). The conduct of foreign exchange market intervention described by Micossis and Bini-Smaghit (1990) reveals an important difference between Germany and the other participants. Intervention to support intra ERM rates in predominantly intra-marginal and hence not obligatory. In practice, out of all the members of the European Monetary System (EMS), it is Germany that plays the most negligible role in these operations, with any changes in its reserves being fully sterilised. This suggests that the other members target intra European Monetary System (EMS) exchange rates while Germany provides the nominal anchor. (Micossis and Bini-Smaghit, 1990).

Further evidence consistent with Germany's leadership is provided by Giavannini[13] and Giavamini[14], who observe that the differential between French and Italian offshore (Euro-currency) and domestic interest rates widens its anticipation of a realignment, whereas German interest rates show little sign of disturbance. This if not anything else, conveys the asymmetrical operation of the European Monetary System (EMS) despite the appearance of symmetry and confirms that Germany may not have dominated, but it has led.

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[13] Giavazzit, Giovavini, *Limiting Exchange rate flexibility: The EMS* (Cambridge), 1989, pp.69-71.

[14] Giovannini. A., *European Monetary reform: Progress and prospects* Bookings papers on Economic activity (Cambridge), 1990, pp.217-91.

European Monetary System (EMS): Political Economy Balance Sheet

The European Monetary System (EMS) certainly the most important manifestation of the macro-economic dimension of the European Currency (EC) which, until the adoption of the Single European Act remained at the margin of Community's activities. Its birth was greeted with considerable scepticism which has been gradually replaced by a growing consensus about the practical achievements and shortcomings of the systems. Meanwhile, interest in the European Monetary System (EMS) currencies collectively as well as on intra. European monetary system (EMS) has been constantly growing, as witnessed by the large number of plans put forward and the lively discussions taking place in official and academic circles which may make one believe that European Monetary System (EMS) is likely to remain high on the European political agenda for many years.

But one must not forget that European Monetary System (EMS) is certainly not a self-contained system. International monetary developments and especially shifts in market sentiments towards the US dollar have a considerable effect on European Monetary System (EMS) currencies collectively as well as on intra European Monetary System (EMS) exchange rates. Coordination of national monetary policies vis-a-vis the dollar is still in an infant stage, although a few attempts have been made in this direction as evidenced for example by the Glengeagles agreement[15] in September 1986. The early period of the system was marked by the strength of the

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15 Laukas Tsoukalis, *The political Economy of the European Monetary System*, in *The Political Economy of European Integration* (Oxford: Basil Blackwell), 1996, p.65.

US currency, while in more recent years the continuous depreciation of the dollar has contributed significantly to increased tension between strong and weak European Monetary System (EMS) currencies.

But what European Monetary System (EMS) has done is that in a world of generalized floating, characterized by high instability of exchange rates, it has helped to curb over shooting and also to avoid long periods of misalignment of participating currencies.

The European Monetary System (EMS) has also served as an important instrument in the fight against inflation. The system of stable exchange rates and the pegging of national currencies to the Deutchemark have created an external discipline which seems to have reinforced the determination of national authorities in the pursuit of anti-inflationary policies. In this respect, the operation of the European Monetary System (EMS) until now can be seen partly as a function of a particular economic conjuncture in which the fight against inflation constituted the first priority of western European governments.

The European Monetary System (EMS) has also laid the foundation for development of a European currency. While the official (ECU) remained underdeveloped and underutilized, the private (ECU) market has developed rapidly. The ECU quickly reached the fifth rank in terms of assets and liabilities of commercial banks, after the US dollar, the Deutchemark, the Swiss franc and the yen. A similar development has occurred with respect to the European Currencies Union (ECU) bond market. The European currencies Union (ECU) exchange market has also expanded significantly, and the new currency has had some limited use in the foreign trade of individual European currencies countries.[16]

There is however, also some truth in the some what cynical argument, namely that the growth of the private ECU is mainly a reflection of the still insufficient convergence among participating economies. Interest rate differentials have been a determining factor behind the issuing of European Currencies Union-denominated loans. Most of the borrowers have come from countries with high nominal and real interest rates, such as France and Italy, while investment has been generated mainly from the Benelux countries, where low interest rates have prevailed. The declaration of the growth of the European Currencies Union (ECU) market in 1986 was largely attributed to the reduction in the interest - rate differential between the European Currencies Union and the DeutscheMark.

Next the combination of a system of relatively fixed exchange rates based on a DeutscheMark standard and the lack of a real and symmetrical co-ordination of fiscal policies may have produced a deflationary bias, thus further reducing the margin of manoeuvre of the weaker economies. There is, however an alternative and not altogether implausible thesis, namely that the countries with weak currencies have purchased extra-credibility in their fight against inflation by linking their currencies to the DeutscheMark.

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[16] Ibid, p.68.

In discussing the leading role of Germany in the European Monetary System (EMS) some have agreed.[17] that this asymmetry was inevitable either because of the particular economic conjuncture - anti inflation priority - or because of the very nature of a fixed exchange rate system. Comparisons have been drawn with the role of Britain in the Gold standard and that of the United States in the BrettonWoods system, often in the context of the so-called hegemonic - stability theory. But leaving aside the many problems which arise in trying to apply the theory of public goods to international or regional monetary systems and in identifying the nature and source of instability which in turn leads to the need for a hegemon the role of Germany in the European Monetary System (EMS) differs in many respects[18] from previous historical examples.

First of all, the leading country in the European Monetary System does not provide the financial centre for the region as a whole. Second and more important is that unlike Britain and the United States in the past, Germany has not adopted a policy of "benign neglect" towards its balance of payments. On the contrary, German economy has very much relied on export led growth, with some clear elements of mercantilism in the policies pursued. Germany's bilateral trade surplus with the other members of the European Monetary System (EMS) (with the exception of Ireland and Netherlands) have been growing rapidly since 1979, thus adding to the delusionary pressure on other countries. That the European Monetary System (EMS) in itself must

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17 Ibid, p.69.

18 Ibid, pp.68.70.

have played some role in the leading position of Germany in the economic and monetary sphere is neither consistent with the political balance of power in the region nor with the general Community model of decision making.

INDIVIDUAL RESPONSES TO THE EUROPEAN MONETARY SYSTEM (EMS):

The general attitude towards the European Monetary System appears to be positive in all participating countries. This is true of both political and business circles. There are however, important national differences in the evaluation of the European Monetary System (EMS) experience.

As far as Germany[19] is concerned the European Monetary System (EMS) has undoubtedly developed more favourably than expected or feared, especially by the central bank back in 1978.

It has created an area of exchange rate stability which represents approximately two-thirds of German trade if non member countries which have linked their currencies closely to the DeustcheMark are also included. It has also enabled Germany to gain a competitive advantage against some countries since currency readjustments have not until now fully compensated for inflation differentials. This is partly rejected in the growing bilateral trade surpluses of recent years.

At the same time, there is little evidence of the European Monetary System (EMS) imposing a serious constraint on German monetary and even less on its fiscal

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19 Chris Hockton, "Republic of Germany", David, A., Dykr (ed.) National Economies of Europe, (London: Greenwhich), 1990, pp.32-67.

policy. Thus because of its leading position, Germany may have been able to achieve what is some times considered to be an impossible combination, namely stable exchange rates free capital movements and an independent monetary policy.

France[20] has always attached considerable importance to exchange rate stability. Participation in the European Monetary System (EMS) has also served as an anti-inflationary instrument and as a weapon against protectionist pressures inside the previous socialist Government, especially in 1982-3. Capital controls have been used sometimes very effectively, as a shield to protect domestic agents of interest rates in offshore markets. Successive effective devaluations of the national currency have been the result of an agonizing process trying to catch up with the loss in international competitiveness arising from higher, French inflation rates.

The French have been disappointed with the lack of symmetry in the system, both in terms of domestic and external policies. The German authorities consider progress in Europe only in so far as this means the alignment of other countries' policies to their own priorities. This in a way aptly summarizes the feelings of French policy-makers.

The external discipline function of the European Monetary system (EMS) has been more important in the case of Italy[21], where the Banca'de Italia has used the participation of the lira in the Exchange Rate Mechanism (ERM) as an important anti

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[20] Peter Halimes, "France", David A, Dyker (ed.) *The National Economics of Europe* (London: Greenwhich), 1990, pp.169-181.

[21] Pierella Phci, "Italy", David A. Dyker (ed.) *The National Economics of Europe* (London: Greenwhich), 1990, pp.69-93.

inflationary weapon vis-a-vis Italian industry, the trade unions and even the political class. This may be clearest case of a central Bank trying through the European Monetary System (EMS) to strengthen its position in the domestic process of economic policy-making. The progressive over-valuation of the lira appears to be a deliberate choice. The wider margins of function have given Italian authorities a greater margin of manoeuvre in terms of monetary policy.

As regards the smaller countries[22] the range of choice in terms of economic policy is limited, almost unexpecting of the existence of the European monetary system (EMS). The operation of the system has, perhaps led to an even closer alignment of their monetary policies with that pursued by Germany. This is mainly true of Belgium and Denmark, since the Netherlands had already, at an earlier stage, adopted a DeutcheMark standard. The Benelux countries and Denmark have succeeded in substantially improving their competitive position against the other members of the European Monetary System (EMS) by gradually moving towards an effective a valuation of their currencies in comparison to the situation back in the 1979. Exactly the opposite has happened with Ireland where the economic benefits of its participation in the Exchange Rate mechanism (ERM) are still not abundantly clear.

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[22] Jacques Bhghin, "Benelinx" David A. Dyker (ed) *The National Economies of Europe* (London: Greenwhich), 1990, pp.113-139.

Chapter II

FROM THE ERM TO THE MAASTRICHT

Inception of the ERM

The early steps towards a unified Europe were made against the backdrop of a relatively stable international economic order. The United States retained its status as the pre-eminent Western economic power and all European currencies were fixed to the American dollar. The European Economic Community (EEC) was established in 1958 when the countries namely- France, West Germany, Italy, Belgium, the Netherlands and Luxembourg integrated their economies into a customs union a decade later, wherein tariffs and quantitative restrictions on trade were eliminated and a common external tariff (CET) was erected, agricultural and fisheries policies were brought under the purview of the EC and also steps were taken to harmonize tax systems.[1] Thus the initial objective was of removing barriers to trade rather than usurping the dollar's international role. Throughout the 1960s, however, plans for greater European integration were advanced, culminating in the 1970 WERNER Report. The afore-cited report explicitly referred to the broader ambitions of economic and monetary union, including the irrevocable fixing of European exchange rates.

These aspirations were gained immediate relevance with the breakdown of the dollar-based currency system. With the result, the freely floating exchange rates

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1 Donald J. Puchala, "The economic and political meaning of Europe 1992", in Michael Steinbrg, ed., *The conical Challenges and opportunities of a United Europe* (London: Pinter), 1990, p.20.

proved exceptionally volatile; therefore, a system for stabilising EC exchange rates was put in place. Prior to the establishment of the European Monetary System (EMS)in 1979, there was a pronounced contrast between progress towards economic integration and towards exchange rate stability The EEC was then passing through its first critical phase of expansion, consequent upon the addition of Denmark Ireland and the United Kingdom in 1993 to the original group of six. But at about the same time, European countries were increasingly being forced to allow their currencies to float freely.

It was against this backdrop that the inter-governmental European council decided in mid-1978 to reform the EC approach to exchange rate management and create a zone of monetary stability in Europe.[2] The European Monetary system was born - a system of arrangements to co-ordinate and enhance the effectiveness of currency market management by March 1979, eight EC currencies (including the Luxembourg franc) were trading according to rules dictated by the new Exchange Rate Mechanism they pledged to keep their currencies exchange rates closely linked, and even before that some national, international and business accounting began to use a standardized European unit of account-the ECU.[3]

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2 Ibid. p.39-56.

3 Robert Minikin, *The ERM Explained* (London: Kogan Page), 1993, pp.12-13.

Its Operations

[4]Having created the ECU, the European central bankers then set about outlining the new system for linking exchange rates together. In the previous attempts to do this the value of currencies was fixed against something external - for many years against the value of gold and more recently against the US dollar. This time they decided to link up all the different currencies with each other. Once the EC central bankers and finance ministers had reached an agreement on the level at which the currencies should be linked up, they announced central or 'parity' rates for each national currency in terms of the ECU so that exchange rates for all the European currencies could be calculated. The recent newcomers to the system had their currencies within a wider range to give their authorities greater flexibility. It was hoped that as their economies became similar to the more established members, and market confidence in their membership grew, the wide range would eventually be narrowed.

Thus, the ERM acted as a parity grid, where national currencies would be tied together, similar to the previous "Snake". However, weaker currencies, it was argued, would be better served by a "basket" method, since intervention under this system would be unilateral. Not surprisingly the Federal Republic of Germany (FRG) preferred the grid system which would require all participating members to intervene if an exchange rate suffered wild fluctuation in value. However, the ERM differed from the Snake in that the ECU would act within the grid as a "denominator" or as

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4 Ibid, pp. 14-15.

a measurement of the central rate within the grid, and also thereby send a vital signal to all participants - a divergence indicator if a currency was moving away from its designated parity value. This room for movement of currency values was set at a maximum of 2.25% either side of the central ECU value.[5] However, Italy and the UK, which eventually joined the ERM in November 1990 are permitted a wider room for movement which is 6% either side of the central parity value. If a currency moves more than 75% of the maximum allowable fluctuation rate, the government and central bank of that country are expected to intervene to stabilize the currency's movement. On the whole, this system was favoured by Germany, since intervention would most probably be undertaken by the country with its exchange rate at the lower limit of the parity grid whereas for the country with the stronger appreciating currency, there would be less pressure for central bank intervention.

The ECU acts within the ERM as a basked currency. It is composed of all ERM participating currencies' value, each currency being weighted. Therefore, as the values of some currencies react, so too does the overall value of the ECU.[6]

The other element of the EMS, the European Monetary Cooperation Fund (EMCF), was based closely on the earlier credit facility of the SNAKE, FECOM. The EMCF would act as a pool for approximately 20% of participating members' gold and

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5 Clive Archer and Geoha Butlir, Economic and Monetary union in The European Community: Structure and process, (London: Pinter), pp. 82-85.

6 Commission of the European Communities, *Eurobarometer* (Brussels), no. 30, December 1988, pp.45-51.

dollar recovered in exchange for which members would receive ECU deposits in order to settle any internal debts arising from intervention over exchange rate fluctuations.

The final element of the EMS was expected to constitute a number of credit facilities, available to all participants. The question of credit being made available to those states with weaker currencies was an important area for negotiation. For it very 'short term' and 'medium term' loans were introduced in order to provide states with the wherewithal to intervene over their currency fluctuations, and were repayable over different time periods according to their nature. It was expected that over time, the administration of these credit facilities would be assumed by the EMCF.

Regarding the question of eco polity convergence and interest rate stability within EMS, there is hardly any clear agreement that the EMS in itself has brought about the reduction of inflationary tendencies within it members. What tends to be stressed as more relevant here is the political will of both EMS and non -EMS member states to control and reduce their inflation rates during the 1980s. Within the EMS, his political will resulted in high-inflation states as Italy and France agreeing to adopt Germany's economic and monetary discipline and this is known as 'policy credibility' whereby weak economies can borrow credibility from their close links to a low-inflation economy. Perhaps one of the more fundamental constraints of the EMS concerns both its structure and process its asymmetric nature and its description as a 'DeutscheMark Zone'.

In essence, the problem of an asymmetric EMS is perhaps not so surprising It is clear that a country with low inflation, good terms of trade and a strong currency would dominate any monetary system, irrespective of any political desire to do so. Such economic and monetary discipline can be useful to other members, and for the functioning of the system itself, "a system of fixed but adjustable exchange rates needs a firm anchor, which in present circumstances can only be provided by the major partner currency and the monetary policy that stands behind it"[7]

Another issue concerns the question of narrowing the margins of permissible fluctuation for ERM currencies. This, it is argued, would render the EMS even more anti-inflationary and reduce even more the presently low levels of exchange rate volatility, but could result in further unemployment or regional economic disparities, thereby strengthening the traditional argument of real resource transfers. And, finally, the EMS of course operates within the parameters of the international economic and financial system, and is therefore affected by strengths and weaknesses of the US dollar and US trade and budgetary deficits.

There has thus been a school of opinion suggesting a radical overhaul of the EMS and a 'relance' of the concept of EMU, rather than a continuation of the piecemeal thinking with dysfunctional elements of the present EMS ".... the problem will emerge of the contradiction between full trade integration, complete ignobility of capital fixity of exchange rates, and as yet unchallenged national autonomy in the conduct of monetary policy.....[8] the only solution to this contradiction that does not entail the undoing of the common market is to move towards a monetary union".

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7 Rieke 1990, p. 30

8 Padoa Tomasso, "The Road to Monetary Union in Europe: The Emperor, The King and The Genies", (Oxford), 1989, p.383.

ERM - Evaluation

After some early experimentation with fixed but movable exchange rates in a system known as the 'SNAKE', Europe launched its Exchange Rate Mechanism in 1979. Its initial membership of eight countries swelled over the next decade and by 1992 all EU currencies except Greece had joined it. Other currencies with close economic links, such as Austria, Sweden and Finland, also linked their currencies with varying degrees of closeness to it.

As per the scheme of things, several currencies would rally round their floundering partners by realigning up or down marginally rather than allowing the one to fall heavily on its own. This was in their own interest to do so to prevent any one country from gaining a sharp competitive edge over the others by devaluing its money- ERM members thus tended to cooperate rather than compete with their currencies.

Currency stability in Europe, as predicted, boosted trade, investment and consumption. But the ERM also brought more general improvements in economic management. It imposed greater discipline on government's handling of public spending and the money supply, spreading lower inflation across all ERM countries, thanks to the key role played in the system by the DeutscheMark.[9]

In the 1970s, many ERM members had chosen to blend some inflationary discipline with a slow but regular weakening of their currencies against the

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9 Leon Brittan, EMU: The end of a dream in Leon Brittan ed., *The Europe We Need* (London: Penguin), 1994, p.41.

DeutscheMark but during the 1980s, the western world began to develop a different collective, will of macroeconomic policy. The long-standing orthodox rather than running higher inflation rates would help to bring down unemployment, encouraging governments to focus on curbing inflation as the central target of their monetary policies. As a result, ERM countries grew more willing to fight inflation by overvaluation, holding their exchange rates constant and exorcizing price increases from their economies by exposing them to the full force of competitive prices in Germany.

In their zeal to secure stable exchange rates through the ERM, as they did so successfully from 1987 to 1992, its members in fact failed to operate the ERM as its founders had intended. One of those founders, former German Chancellor Helmut Schmidt made it clear when Britain was forced out of the system in September 1992. It was always intended that there should be a realignment of exchange rates if the pressure upwards or downwards on a currency was so great that it could not be stopped by central bank intervention in the markets, or could only be stopped by changes in interest rates of an extent altogether unsuitable or damaging to the economy concerned. Instead governments had resisted realignments at all costs, in the mistaken belief that such alignments could be altogether avoided, and that this was the best way to move to a single currency.

Nevertheless, this appeared not to matter in the late 1980s and early 1990s, for ERM numbers seemed to be successful in tracking German monetary policy very closely, shadowing cuts and resetting in key German interest rates almost instantly, and avoiding forced devaluations as a result. In practice they had surrendered their independence over interest rates to Germany, although legally it remained in their hands.[10]

But the shock of German unification drove a wedge between the economic performance of Germany and its ERM partners. West Germany effectively bought up the East German economy overnight, and the cost far outstripped even the most alarming estimates. In 1990, private-sector German forecasts put the bell for reunification at 115 billion DeutscheMark between 1990 and 1994, or about 25 billion DeustschMarks per year. But by mid-1993 estimates of the cost from 1994 onwards had risen to 65 billion DeutschMarks. The government argued that it was politically impossible to raise taxes enough to absorb reunification costs which left the Bundesbank with little option but to raise interest rates, and the rest of Europe felt the pain of the resultant recession.

Economic and finance ministers and the governors of Europe's central banks fussed over the patient, studying whether its sickness stemmed from its flaws in its very autonomy. They prescribed no fundamental changes, concluding simply that the system should be run as initially intended with currency realignments taking place whenever necessary.[11]

At pains to avoid the impression that ERM was finished, they loosened it as for as possible without breaking it: ministers agreed to stretch the degree of permitted

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10 Ibid, p.44.

11 Economic And Monetary Union, ECSC-EEC-EAEC, office for official publications of the European Communities, (Luxemburg), 1991.

fluctuation from 2.25 % to 15% either side of the central parity. This sent two signals, one economic and the other political. It gave currencies more undergrowth in which to hide from speculators, who could no longer assume governments would realign exchange rates if they needed to cut interest rates and it was hoped that observers of European integration would be reassured that the ERM was alive and recuperating end it was wrong to harbour the assumption that it had taken all prospects of Economic and Monetary Union down with it.

Pre-Maastricht : A Decade of Relative Stability

The 1979 reforms heralded a new era in European management of the currency markets. The first four years of the system, brought seven realignments with their magnitude marginally greater in 1983 than in 1979[12]. The commitment to stable exchange rates failed to effectively constrain national policy-makers over this period. The 1983 realignment proved a turning point for the system as it was accompanied by more prudent economic policies in France and institutional change in Italy.

Exchange rate stability was now in the mainstream of the trend towards greater EC integration. While the 1970s approach to currency management had gradually lost members over time, the European Monetary system added them. New curricles were included in the EMS as the Community expanded southward, the Spanish Peseta entered the ERM grid in 1989 followed by Sterling in 1990 and the exudo in 1992.

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12 Robert Mihken, How the Exchange Rate Mechanism Operates in *The ERM explained* (London: Kogan Page), 1993, pp.22-26.

An important strength of the EMS has been its ability to evolve to meet the difficulties which have arisen in practice. Any regime of pegged exchange rates not only require a set of rules governing the behaviour of the central banks, but that these rules should be followed. The January realignment occurred in particularly heated circumstances amid accusations that the Bundesbank was doing too little to dampen the DehtscheMark. The Basle-Nyborg agreement of that year opened the way for central banks to draw on credit lines to finance intra-marginal intervention It also gave a greater role for the ECU in repayment of short-term credits.

Some aspects of the system have not worked as planned. It was hoped that the 'divergence indicator' would trigger action when economic policy in a single currency got out of line with the rest of Europe[13] In practice, the indicator has not played an important role in the operation of the ERM. The new ECU currency has also been rather side- lined- it has a book keeping role within the European Monetary Co-operation Fund (Which administers the short- term credit lines) but has been little used for direct intervention.

The ERM had been a symmetrical framework - without a single anchor currency - by design. However, in practice, the DeutscheMark quickly assumed the role of key currency within the system.[14] When a currency came under downward pressure it was particularly important if its cross rate against the DeutscheMark was pressing such as the Belgian franc was kept within even narrower band around the

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13 *European Economy* (Prussels), no.12 (July 1982).

14 The Divergence indictor: A Technical Note, International Monetary Fund, *Staff Papers* (Washington DC), vol.28, December 1981, pp.687-97.

DeutscheMark central rates than the rule of the system demanded. Throughout 1991, the Belgium franc traded within a 1/2 percent of its central rate against the DeutscheMark - this along with the Dutch guilder were considered 'core' currencies. Over this period, the French franc traded within its narrow 2 1/4 percent band - it along with the Irish pound and the Danish Krone were in an intermediate bloc. Finally , settling DeustcheMark remained relatively volatile within the ERM and was included in the lowest grade of ERM currencies.

The role of the DeutscheMark in the ERM was both a strength and a weakness.[15] It can be regarded as a strength as the Bundesbank is providing a non-inflationary anchor to the ERM currencies, which other system of pegged exchange rates (such as the post-war dollar standard) have lacked. A devaluation of the DeutscheMark has never been required. On the other hand the hoped for symmetry in the system, with both central banks countering pressure on a particular exchange rate has not come to fruition. The central bank defending a weak currency still bears the greater part of the burden and substantial increases in interest rates may be required. An analysis of international interest rates makes this asymmetry very clear. Where realignment pressures have developed, the interest rates paid on the weak currencies have risen very sharply while DeutscheMark rates have edged only fractionally lower. As a result, it can be argued that the ERM has become very similar to its predecessors, but with the DeutscheMark, rather than gold or the dollar,

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15 Robert Menikeu, "How the Exchange Rate Mechanism Works" in *The ERM Explained* (London: Kogan Page), 1993, p.26.

at its heart. If realignments are to be ultimately phased out and Germany is setting interest rates to meet its domestic requirements, the monetary policy in the Community may be excessively delusionary.[16]

The Delors Report

The dissatisfaction with the dependence of the European Monetary System (EMS) on the German DeutscheMark which meant that the Bundesbank had become an unofficial EC central bank, further convinced the majority of member states of the need to renew their pursuit of monetary union, long simmering as an idea on the Community's back-burner. In 1988, at the Hannover meeting of the council of ministers, it was decided (with support from the UK) to establish a committee with the objective of "studying and proposing concrete stages leading towards economic and monetary union".[17] The powerful committee was headed by Jacques Delors. It also included the governors of the 12 national banks. On 17 April 1989, the committee produced the so-called 'three-stage plan for economic and monetary union'.

Although the Report did not set out the timetable for moving to the final stage of EMU it did as requested by the European Council in 1988, set out quite clearly the concrete stages that would be needed to attain EMU if the will to do so existed.[18]

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16 Ibid.

17 Mark Wise, Richard Gibb, "The Community in the 1990s", in *Single Market to Social Europe* (London: Longman), 1993, p.292.

18 D.M. Harrison, "Economic and Monetary Union", in *The Organisation of Europe* (London: Routledge), 1995, p.108.

The immediate background to the Delors Report was a decade of largely positive experience of the European Monetary System (EMS), added to the impetus towards further integration created by the single market programme. The European Monetary system founded in 1979, had three main features: commitment to relative exchange rate stability through the Exchange Rate Mechanism (ERM) under which participating member states agreed not to let their currencies diverge by more than a small amount (2.25%) from a central pivotal rate, machinery for intervention to support currencies, including significant credit arrangements between the central banks and the creation of the basket currencies known as the European Currently Unit (The ECU) as the core of the system, both in firms of an accounting unit and as the reference unit from which divergences of currencies are calculated.

By 1989 the EMS had a good first decade of existence.[19]It had largely succeeded in establishing (or re-establishing an island of comparative internal exchange rate stability in a world of currency turmoil. Exchange rate realignments became less frequent and inflationary pressures were cooled by the alignment of other members states monetary policies or those of the Bundesbank in itself committed by law to a policy of safeguarding the currency.

Yet, there were imperfections. The DeutscheMark (not the ECU) had become the real core of the system. Although this brought benefits in terms of exporting

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19 Commission of the European Communities, Fourth Progress Report of the Commission to the Council and the European Parliament concerning the Implementation of the Commission's White Paper on the completion of the Internal Market, 30 June 1989, p.6.

German sound money policies to the rest of the ECP, it also had some drawbacks. It placed undue and unsought weight on domestic German monetary policy decisions such as interest rate changes which had repercussions far outside Germany including, among countries not formally members of the ERM.

A combination of both these successes and these problems within the EMS, added to the fact that the single market programme was expected to increase the volumes of cross-border economic transactions and these made a single European currency more attractive. This led to a majority view in the Community in around 1988 that the time was ripe for a renewed attempt at shaping up EMU.

The Delors Report made a number of important points which are worth recalling. First, it contained a useful working definition of EMU, as follows:[20]

> "Economic and Monetary Union in Europe would imply complete freedom of movement for persons, goods, services and capital, as well as irrevocably fixed exchange rates between national currency. This, in turn, would imply a common monetary policy and require a high degree of compatibility, consistency in a number of other policy areas, particularly in the fiscal field. These policies should be geared to price stability, balanced growth converging standards of living, high employment and external equilibrium. Economic and Monetary Union would represent the final result of the process of progressive economic integration in Europe".

The original blue print for EMU was composed of three stages.[21]

(1) Stage I, where all EC member states would be full members of the ERM

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20 Delors Report 1989, paragraph 16.

21 Clive Archer and Fama Butler, "Economic and Monetary Union", in *The European Community Structure and Process* (London: Pinter), 1992, p.81.

- where the maximum permissible range of fluctuation for all participating currencies would be 2.25 per cent.
- where exchange controls would be removed to allow the free movement of capital.
- where monetary policy co-ordination would be increased under the aegis of the committee of Central Bank Governors.
- where a European Revenue Fund would be created to pool 10 per cent of national foreign exchange reserves in order that intervention would be facilitated by either national authorities or the Fund.

In short, stage I of the Delors Report on EMU is intended to increase national co-operation and co-ordination over monetary policies, exercise uniform discipline over all the EMS currencies and begin to develop the ECU.

Stage I is therefore a vital first step towards EMU. This is so because fundamental political and economic interests have to be reconciled, both within national boundaries and between national and supernational centres of power.[22] This is evidenced clearly in the British Parliament debates over loss of sovereignty as a result of any further federal integration.

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[22] Jacques Delors, *1992: The Social Dimension*, Address to Trade Union Congress Bourrnemouth, 8 September 1988.

Stage I was also defined as coming into effect from 1 July 1990 - decided upon at the 1989 Madrid council - and in June 1990, the Dublin council got the starting date for the IGC leading to treaty revision in December

(2) Stage II, as envisaged in the original Delors Report, would involve limited intervention within the ERM, in other words, only in special circumstances and would present an important and intensive stage for the development of institutional mechanisms for EMU - Eurofed or the European system of Central Banks would be set up gradually to assume control of national monetary policy as laid down in the revised EEC Treaty.

This stage was initially agreed to commence in 1994, although Britain did not support this date.

(3) Stage III[23] of the Delors Report is characterized by the permanent fishing of exchange rates which would ultimately be replaced by a single European currency - the tune and characteristics of which, the Delors Report envisaged, would be agreed to during the treaty revisions of the IGC, and the European Central Bank would assume total control of national monetary and economic policy.

At the Rome Council in December 1990 the EC's member states, except for the UK, agreed that the move toward stage III should be discussed by 1997.

Adopting a single currency rather than having national currencies with irrevocably fixed exchange rates would not only have a symbolic character. It

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[23] Clive Archer and Frona Butler, *Economic and Monetary Union: The European Community Structure and Process* (London: Pinter), 1993, pp.113-119.

constitutes a point of no return.[24] Also it totally eliminates transaction costs. The maintenance of several currencies would leave in existence residential transaction costs on small sized operations, and make marked transparency less than full. The existence of distinct capital markets would not allow the economies of scale associated with monetary union to be exploited completely so to eliminate the hurdles in the way of making Europe a genuine monetary entity. The Delors Report described clearly "how the single most important condition" for monetary union would be to lock exchange rates irrevocably. Only after which but nonetheless "as soon as possible" national currencies should be replaced by a single currency.

Next, the report proposes a new European institution to take responsibility for the common European monetary policy which would need to accompany locked exchange rates, and which would allow centralised and collective discussions on such key matters as the supply of money and credit and instruments of monetary policy like interest rates. This institution was the European system of Central Banks. Independent of instructions from national governments it in itself would have two main parts, the European Central Bank proper and the existing national central banks.[25]

The report also suggested a series of three stages of movement towards EMU, of which the third stage would be the vital one of locking exchange rates. Although the report suggested that there should be a clear indication of the tuning of the first stage, it added that the setting of deadlines, in particular for the move to irrevocably

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[24] European Economic and Monetary Union, Office for the Official Publication and European Communities, (Luxembourg), 1991, p.17.

[25] Delors Report 1989, paragraph 43.

fixed exchange rates, was not advisable. In the light of the exchange rate crises of 1992-3 the language bears repeating "the conditions for moving from stage to stage cannot be defined precisely in advance, nor is it possible to foresee today where these conditions would be realised."

In addition the Report argued that although within an economic and monetary union there will still be scope for independent policy making by national governments there must be limits to national economic behaviour which could destabilise the monetary whole, and this applies particularly in the budgeting field, where binding rules are required in matters such as national budget deficits and borrowing policies.[26]

As has been the experience, the completion of the monetary union does not imply, however, the immediate establishment of a single currency, which may require a technical and psychological delay in order to deploy the new payment instruments and prepare the public at large to use them. But the final objective must be clear: Europe needs a single currency. This choice influences the conception of the institution that will be responsible for issuing and managing this currency.

From the beginning of stage III, the Community institution created during the preceding stage would be solely responsible for defining the Community monetary policy. This centralization removes *a priori* any possibility of conflict between

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26 D. M. Harrison, *Economic and Monetary Union, in the Organization of Europe*(London: Routledge), 1995, p.110.

different monetary policies within the zone.[27] This institution would also guarantee unlimited convertibility of the different national currencies and the facility of their parties. These currencies would thus be perfectly substitutable and by definition there would be a single monetary policy.

[27] Economic and Monetary Union, Office for Official Publication of European Communities, (Luxembourg), 1991, p.17.

Chapter III

MAASTRICHT TREATY AND THE CRISIS OF 1992

The Single European Act

The European Council decision in Milan (1990) to convene an inter-governmental conference to consider the future of the EC and a possible revision of the founding treaties had been taken, uniquely for the Council, upon a majority verdict. To some extent therefore, the degree to which momentum for change, which had steadily but surely been built throughout the 1980s, could be sustained, was dependent upon the three recalcitrant member states at Milan - Britain, Denmark and Ireland. While disagreeing with the majority decision, all three, however, felt constrained to participate in the proposed conference, if only to continue their advocacy of a minimalist development.[1] And in the end the afore-cited three states in minority could take comfort from the fact that any outcome that might emerge from the proposed conference would have to be by unanimous decision. Other member states almost invariably in favour of institutional reform and significant advances towards European Union, lent their weight to the need to obtain a positive result from the conference even if against the wishes of the three sceptical states. The formal proposal put forward by the new Luxembourg presidency of the European Council was that the conference should consider revision of the treaties "with a view to

[1] Derek W. Urwin, Towards 1992 in *The Community of Europe* (London: Longman), 1996, p.229.

improving Council's decision-making procedures", the Commission's executive power, increasing the power of the European parliament and extending common policies to new fields of activity".[2] This paralleled the brief from the European Council for a study of the institutional condition in which completion of the internal market could be achieved within the desired time limit".

On the basis of the proposals received from the intergovernmental conference, the European council accepted in principal a number of texts referring to specific areas of projected action that were brought together into a Single European Act. In essence the Single European Act (SEA) was an attempt to turn the EC back towards the original goal of a common market set out in the treaty of Rome, Something which in 1957 had optimistically been scheduled to be in place by 1970. In that sense the SEA was not a revolutionary document; on the other hand, in its proposal for institutional change it had the potential for revolution, suggesting a shift in the existing balance of power away from the member states towards the Community institutions and a reduction, therefore, in the blocking power of states which found themselves in a minority.

At the heart of the SEA by the commitment to a fully integrated internal market by the end of 1992, summarised by the Commission draft that was the basis of discussion of Luxembourg as an area in which persons, goods and capital shall

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[2] ibid, p.230.

move freely under conditions identical to those obtaining within a number of states.[3] The market was central in the sense of being fundamental to the initial logic of the treaties. Tactically, it was one of the few moves which would meet little resistance from more reluctant countries like Britain and Denmark. Establishing the market would entail the removal of all those barriers and factors which inhibited free movement. Inside the EC the benefits would, it was believed, accrue in the medium term to the consumer through the consequent greater specialisation of production at the company level and the economies of scale. Externally, the single market was meant to strengthen EC competitiveness in world markets, especially against the US and Japan.

The SEA was a significant development as it inevitably focused attention not just on 'isolated' instances of national discrimination. But ultimately on the whole range of national systems of taxation and law, the plethora of national standards and regulations in a range of policy areas, and national social welfare and security systems.[4] At the extreme it implied the abolition of all internal frontier controls - whether of goods or people. This implication had been accepted by the five countries - Belgium, France, Luxembourg, The Netherlands and West Germany - which in June 1985 signed the Schengen Agreement, a commitment to create a border free zone among themselves. Indeed, the implications of the SEA would affect and its success

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3 C. Ehrlermanh, "The institutional development of the EC under the SEA", *Aussenpolitik* (Hamburg), vol.41, no.2, 1990, pp.135-46.

4 Andrew Moravisik, "Negotiating the Single European Act", in *International Organisation* (London), vol.46, no.2, 1992, pp.533-560.

or otherwise would be affected by factors, beyond the narrow field of economics and trade, factor such as the linguistic diversity of the EC and the mosaic of national pattern of culture and traditions. Far from dominating political integration from construction, the implication of the SEA almost guaranteed its return to the agenda.[5]

Potentially, the most important significance of the SEA related to its institutional reform, since it implied a modification of the power structure of the EC. However, for the proponents of European Union perhaps the most disappointing element of the SEA was that it fell far short of the proposals contained within the European Parliaments own Draft Treaty. Yet, the SEA was a reasonably comprehensive attempt to sweep away the logjam to which the EC was prone and to streamline some of its activities. It was inevitable but perhaps also shrewdly, this was a package which contained something for everyone. It confirmed the end of 1992, as the target date for the internal market, with the Commission being obligated to report on intern progress in 1988 and 1990 but in such a way that failure to meet deadlines would not automatically incur any legal penalties.

Because the SEA involved a revision of the founding treaties, it had to be sent to the national parliaments for ratification. Several leaders had already expressed reservations about some elements of the package and their implications Britain[6] was more than doubtful about the social dimension of 1992 and about the European Union

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5 J. Story, "The latching of teems: an analysis of change in foreign economic policy", (London: Pinter), 1988, pp.397-412.

6 G. Davies, "Britain and European Monetary Question", IPPR Economic Study, (London), 1989, p.1.

while France disliked the extension of EPC. Italy complained that the proposals relating to the European Parliament were totally inadequate. At the extreme, while Denmark reserved its position on almost everything, Greece delayed its ratification. Finally after a major hiccup in Ireland was over the SEA came into force in 1987.[7]

The Road to Maastricht

The SEA had not met the EP's demand for a major overhaul of the EC, nor did it in itself advance European Union very far. Its direct effect upon the institutional balance of power within the EC was rather limited. It seemed clear that the European Council would remain the main repository of power in the EC, and despite the continued rhetoric in favour of European Union, there remained a question mark over the willingness of national governments to relinquish in the last resort their grip over determination of the EC policy. But there was more to the SEA than this. It was a significant step, and one which had been initiated approved by the European Council, the body which in the 1980s ultimately held the key to any further integration. Indeed, the Commission had already taken up the task with gusto. At the 1985 Brussels summit the European summit the European Council had asked the Commission to draw up a detailed timetable for completion of an internal market, Lord Cockfield, the British Commissioner who had been given responsibility for the internal market, rapidly produced a long list of some 300 separate measures relating to physical, fiscal

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[7] J. Kellas, "European integration and the regions", *Parliamentary Affairs*, vol.44, no.3, 1991, p.311-24.

and technical barriers to trade that would need to be implemented.

The objective of 1992, according to the Commission was the idea of a 'Europe without frontiers'.[8] At the heart of this concept, which certainly could imply something more than a mere economic community, lay frontier and customs controls- which themselves are atleast partly a matter of taxation. It was the tax proposals which created Critical debate. Denmark, for example, with its high VAT rate would lose considerable revenue, at the other extreme, Britain, with its zero VAT rate on a range of items feared a rise in the cost of living. The Commission seemed to become more aware of this potential danger. Certainly, within two or three years some critics were accusing it of pursuing not a policy of harmonisation- a reasonably close approximation of national policies - but a more rigid one of homogenisation. But the EC was unable to resolve the question of tax harmonisation, and a more limited compromise was slow in coming.

In 1989 Jacques Delors became the first president since Walter Hallstein to be re-elected for a further tern in office. This move by the Council of Ministers was designed to maintain a degree of continuity within an acerbating programme of integration that had spread to embrace not just the single market but also a major E reorganisation that would incorporate further steps towards monetary and political union.

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8 Stanley Hoffman, "The European Community and 1992", *Foreign Affairs* (New York), no.4, Autumn 1989.

Delors' major initiatives beyond the SEA were directed towards the achievement of three broader ambitions. They were on EMU, the budget, and the social Charter. In each of these the conflict was not necessarily between the Commission (and the EP) on the one hand and the two councils on the other, but between those who wanted a maximisation of integration and full union as quickly as possible-for whom Delors became the principal advocate-and those who desired the economic single market, but beyond that only cooperation. The major proponent of the later viewpoint was, not surprisingly, Mrs. Thatcher.[9]

At the same time as the EC wrestling with the SEA and its consequences, it had to confront the persisting problem of budgeting and the demands upon its resources. And one way or another, budgetary problems had been dominating theme of E discussions and agreements for almost two decades. The enlargement of the EC, the issue of the British contribution and the rising costs of the CAP were but the major ingredients that had ensured that the budget remained high on the agenda. Agreements over reassurance and allocation continued, at times with as much vehemence as in the past, but they had arisen out of the renewed drive after 1984 towards further integration. It was not surprising therefore that the opposition Mrs. Thatcher, the most vigorous advocate of minimalism was much more forthright when

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9 Sonia P. Mazey and Jerney J. Richardson, "British Pressure Groups in the European Community: The Challenge of Brussels", *Parliamentary Affairs* (London), vol.45, no.4, 1992, pp.94-95.

it came to two of Delors other initiatives.[10]

One of the arguments for a Social Charter, a programme for a minimum set of workers and citizens rights which Mrs. Thatcher labelled as 'Marxist' while the social charter per se may not have been very revolutionary, Britain was perhaps correct in fearing that it might be then the end of an integrationist wedge. The same was true of the other area where Mrs. Thatcher and Delors came into conflict: monetary policy. This had, by and large, been something of a missing element from the SEA, but, as with working conditions, the logic of 1992 demanded that it be addressed. Delors took up again the quest for EMU, including those ingredients essential for it to be truly effective - a single central bank and a single European Currency - after being requested to do so by the European Council in June 1988. Britain, still only a partial member of the EMS rejected the idea of EMU as unnecessary for the creation of a single market and withstood pressure to make it reconsider its position although the Thatcher government. Still insisted that it would eventually join the Exchange Rate Mechanism (ERM) when conditions were appropriate. The Delors report on EMU was finished by April 1989. It saw progress to EMU as a three-stage process, with greater harmonisation within the EMS as the first step. The following month the report was accepted by the European Council which, despite Britain's objections set July 1990 as he starting-point for the first stage.

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[10] S. Gorge, Awkward Partner : Britain in the European Community, (London: Macmillan), 1990, pp.105-109.

A report from Mrs. Thatcher was not long in coming. Two months after Delors statement in Strasbourg, in a major speech in Bruges she attacked the speed with which Delors and others were trying to push the EC in area where, strictly speaking, legal authority to act was still in national hands and where she believed pragmatism was being sacrificed in a rush towards a political structure which she disliked and dismissed as unrealistic. Hence her comments that "It is a matter of common sense that we cannot totally abolish frontier controls if we are to protect our citizens from crime and stop the movement of drugs or terrorists or illegal immigrants".[11] Mrs. Thatcher took pains to stress that Britain was committed to the EC. What she was objecting to was towards 1992 in, not only the nature of the Europe that some wishes to construct, but also the fact that the drive was being led by a bureaucratic and unrepresentative Commission.

Both were legitimate views of Europe. The difference was that one was looking beyond 1992 to some kind of political federation or union while the other would be content with a more strictly economic internal market flaked by heightened co-operation among the member states on a host of other issues. It was the debate whose roots lay far back in the past yet because its essential parameters of the debate had shifted further away from intergovernmentalism towards supranationalism through the accumulation of common practices of the past decades.[12] From Fontainebleau to

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11 Derek W. Urwin, "Towards 1992", in *The Community of Europe A History of European Integration Since 1945*, (London: Longman), 1995, p.241.

12 Niel Kinnock, His speech as the leader of the labour party to the Socialist Group of the European Parliament, *Glasgow*, 1988.

the SEA, events had transpired to give the Commission, backed by most of the European Council, a new moments as the driving force of the European Council. What counted was that all the member states had accepted that 1992 symbolised the beginning of something new. It was precisely what the new world would or should like that was in dispute, but the weight of the leadership was solidly behind the efforts of Delors. As the EC moved into the nineties, 1992 was replaced by Maastricht as the catch phrase symbolising the hoped-for transformation. From the SEA through to the 1991 Maastricht debates on constructing a new and more extensive political framework for the EC, a bruised and usually isolated Britain seemed to be waging a lonely and a futile rearguard action against an integrationist juggernaut.

The additional push arose first out of the Delors report on EMU. The Strasbourg summit of December 1989 decided upon the establishment of an intergovernmental conference that would discuss and construct an edifice for monetary union. The following June Britain's resistance to EMU was modified to take the form of an alternative gradualist strategy for the medium tern once the first stage had been completed. By the end of 1990 the agreement seemed to have been sealed. The first EMU stage was in place, Britain had entered the ERM in October, and during the same month the European Council agreed in Rome that EMU would move to the second stage in January 1994.

In 1981, Mrs. Thatcher had bluntly asserted that "there is no such thing as a separate Community interest and that the Community interest was compounded of the national interests of the member states."[13] And despite the rhetoric of integration, it is clear that throughout most of the history of the EC national interests had prevailed. Between 1988 and 1990 the speed of the events had challenged the Thatcher assertion and to a greater or lesser extent all the member states except Britain seemed to have come around to the view the there was a separate Community interest.

The bandwagon of union had been steadily gaining momentum to the extent that as the Community moved into 1991, outside Britain almost everyone-whether enthusiastically for it or fatalistically resigned to it-seemed to have accepted union as a *fait accompli* and to believe that the European Council meeting in Maastricht planned for December would need only to rubber stamp the transformation of the EC and its founding treaties.[14]

It was virtually the last assault on the EC by Mrs. Thatcher. Within months she had resigned as Prime Minister, forced out by a rebellion within her own party occasioned primarily by domestic political factors. To Britain's partners in the EC the new conservative leadership seemed to be rather less hostile and on a visit to Bonn in March 1991 the new prime Minister, John Major, declared that his intention was to place Britain 'at the very heart of Europe'. All twelve member states, at last seemed to be pulling together.

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13 Ibid, n.11.

14 O' CLEIREACAIN, "EUROPE 1992 and gaps in the E's Government Commercial Policy", *Journal of Common Market Studies* (Oxford), no.3, September 1991, pp.201-217.

THE MAASTRICHT TREATY AND THE EMU

The opening of the 1990s saw the EC well on course towards the single market with the commission announcing that most of the necessary directives had been approved. A compromise on VAT had at least been negotiated and several more member states were lining up to join the border-free Schengen Agreement. The Intergovernmental conference opened up in December 1990, charged by the European Council to consider EMU, political union and social dimensions.

Progress was more satisfactory, or at least less contentious, on EMU. By September 1991 the Finance Ministers had more or less completed some additional finishing touches to the 1989 Delors Plan with the first stage already in position, they agreed that the second stage would commence in January 1994, and that the final transition to EMU should come in 1997. However they also insisted that eligibility to anticipate in the final stage would depend upon the member states meeting strict budgetary, inflation and monetary criteria. A sensible economic qualification, this nevertheless seemed to obviate the political objectives of the parallel Intergovernmental conference.

In December 1991 the EC leaders assembled in Maastricht in a mood of high anticipation and tension. Their task was to finalise a treaty framework for EU incorporating political union and EMU, determine a timetable for their implementation and launch the EC along a new security dimension. Kohl's view was that Maastricht was "wresting the Rubicon".[15] There is no going back" because of the high stakes involved. The theatricals were also explosive with Britain in particular being intransigent. British PM John Major may have wished to be at the heart of Europe, but has vision still differed markedly from that of most of his counterparts, and the British determination to resist, which at one stage threatened to jeopardise the whole proceedings, enforce several compromises.

Economic Policy in the Treaty[16]:

One area of the Maastricht negotiations which attracted little controversy was setting out the objectives for economic policy within the EC. The shopping list of aims which economic and monetary union were to promote included.

- A harmonious and balanced development of economic activities.
- Sustainable and non-inflationary growth respecting the environment
- A high degree of convergence of economic performance
- A high level of employment and social protection
- Raising of the standard of living and quality of life
- Economic and social cohesion and solidarity among member states

It is noteworthy that bringing the performance of economies into line was

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15 Derk W. Urwen, "An Even Closer Union ?" in *The community of Europe. A History of European Ontegration Since 1945* (London: Longman), 1995, p.253.

16 Robert Miniken, "What was Agreed at Maastricht" in *The ERN Explained* (London: Kogan Page), 1993, pp.35-36.

regarded as desirable in its own right, not just as a pre-condition for creating a single currency. The Maastricht treaty also very much retains the free market thrust of the European Economic Community Member governments are to act in accordance with the principal of 'an open market economy with free competition'.

Also the treaty makes provision for "broad guidelines" for economic policy to be drawn up at the pan-European level. The European Commission is given the job of recommending what these guidelines should be and the European parliament is informed of what they are. The treaty's approach to budgetary policy in individual countries fits neatly into this guideline approach.

The Timetable Explained[17]:

The initial steps towards monetary union appear rather innocuous. The EC commitment to free competition in open markets is reflected in stage I, with a requirement to remove capital controls. The treaty also requires member states at this stage to adopt long-term economic programmes to create the lasting convergence necessary for monetary union, particulary in the areas of price stability and sound public finance. During stage two, the member states will also ensure that their central banks each conform to the new Pan-European standard in terms of independence. However, it is in stage III, that Delors 'quantum jump in monetary union occurs. And it is on the nature of this jump that the major decisions were taken at Maastricht. At this point, the European Central Bank (ECB) will replace the EMI, and manage

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17 ibid, pp.37-38.

monitory policy for the single currency area. At present there are wide differences in the role of central banks across Europe. The degree of autonomy ranges from the high degree of independence of the Bundesbank to the subservience to politicians of the Bank of England the ECB and the national central banks will be linked together in the European system for central Banks and will follow ECB instructions.

The European Central Bank[18]:

In a treaty where the language lend to be long-winded and heavy wilt sub-clauses, the section on voluntary policy begins with a blunt statement, "The primary objective of the Central Bank shall be to maintain price stability." It then allows the central bank to try to achieve other economic objectives as long as price stability is not prejudiced. This follows the model of the Bundesbank's legislative requirement to seek price stability.

The Bundesbank model is also followed in growing the new central bank independence. The treaty specifies that " ... neither the ECB, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Community institutions or bodies, from any government of a member state, or any others body" It also calls on governments to act in good faith and reject this principle, perhaps recognising that the establishment of independent central banks represents a major change for many European countries. Immediate, direct democratic control over the level of interest rates is voluntarily being given up.

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[18] ibid, p.39.

The ECB will have all the powers of a traditional central bank i.e. setting interest rates and authorising note issuance. It was decided that it will be run by an executive council composed of six members with recognized status and professional experience in the area of money and banking. The governing council formulates monetary policy taking decisions on money supply target and key interest rates. Whatever the precise constitutional positions outlined in the treaty the ECB will in the end be answerable to Europeans and Member Parliaments. The treaty makes clear, however, that national central bank governors are not to be simply representatives of national governments interests. It not only specifies their minimum feature (five years) but outline in some detail the circumstances in which they can be fired.

Criterion For Single Currency Area Membership[19]

To ensure that the single currency area starts out with low inflation and prudent budgetary policies, the Maastricht Treaty sets criteria by which new applicants to the area will be judged and membership granted.

(A)	**Price Stability**:	Over the past year the members have inflation which does not exceed by more than 1½ percentage points the average of the three best performing states. The fall in inflation to this level should be sustainable.
(B)	**Budgetary Policy:**	The Commission should not have judged that the state has an excessive deficit in its budget. Ideally the government deficit will be running at less than 3 percent of national output. And outstanding government debt

19 Leon Brittan, "EMU : The end of a dream in Europe: The Europe We Need", (Dartmouth: Aldershot), 1994, pp.50-52.

will present less than 60 percent of output. It the actual figures have fallen substantially and 'come close' to these values, this may be sufficient.

(C) **ERM Membership:** The Membership states should have maintained its currency within a narrow band for at least two year 'without severe tensions and without initiating a devaluation.'

(D) **Long-Term interest Rates:** In the year prior to the entry request, average long-term interest rates should not exceed by more than 2 percentage points average of the three best performing member states in terms of price stability.

Finally, the commission and ECB prepare report and the final decision rests with the Heads of State. The stringency of these standards is to be judged by the fact that even the strong currencies such as those of Belgium and the Netherlands fail to meet all these standards and must undergo a period of adjustment. For grace there is a distant objective. In order to avoid a widening gap between those aboard a single currency and those still unable to join, or those like Britain and Denmark with the right to think further before committing themselves,there must be tight currency collaboration. This will prove more necessary the more counties join, those government. Which hold out against a singe currency would in theory at least, be in a position where they could exploit their national currency flexibility to give themselves a short term comparative advantage over the others. Clearly the wider the membership of the club, the greater the potential benefits to act in terms of exchange rate stability. and the more powerful the single currency will be influencing world exchange rates and global monetary policy., It is in the Union's interests therefore, to achieve as broad a membership as possible, provided all participants meet the strict rules of admission.

Timetable for the EMU[20]:

The treaty envisages three stages in the evolution towards a single currency. Under stage I, which never formally existed existed nut in practical terms ran from 1990 to 1993, EC States abolished curbs on capital flowing between them, and were supposed to place their currencies within the narrow bands of the ERM. Speculation put an end to these narrow bands, but free movement of capital has remained in place despite the temptation to re-introduce capital controls. Furthermore the main element of stage II still went ahead. As of 1 January 1994, the Union established the European Monetary Institute that would gradually shed its skin and hatch the full European Central Bank.

On the face of it, and indeed until the 1993 crises, stage II looked as if it would be purely procedural, but in fact it weirs in some fairly important policy immolations. First central banks and finances ministries cooperate on a formal footing. Moreover, under stage II, national central banks are supposed to move towards independence from governmental control there by increasing the credibility of their policies in the fight against inflation. Governments are also under an injunction to avoid overspending and running the public purse into deficit.

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20 ibid, pp.51-54.

But stage III contains the most contentious provisions of all, namely the deadlines by which Maastricht envisages the arrival of a single currency Detractors argue that by setting artificial deadlines the Union is frogmarching its governments into a single currency earlier than their peoples may wish and their economies may allow. There were two alternative starting dates-1997 and 1999- by which European countries could fuse their currencies into one and then exact quorum rules for each are different. Maastricht stated 1997 as the year when a single currency was to come into being if a majority of member states were ready and willing to join. Two years later, this need for a majority of countries would lapse. Those who wish to proceed to stage III no matter how few, would do so, provided they met the strict criteria laid down in the Maastricht Treaty.

Furthermore, the Maastricht deadlines have a catalytic effect on governments, focusing their minds on the need to align the way they run their economies, even if they remain undecided about the final destination of a single currency. The treaty has persecuted governments with the deadline and the costs warning that they will be unable to participate, however good they may think they are as Europeans, unless the gap between varying performances of their economies. In the case of Spain, for example, the drive to meet the conditions for a currency union has enabled the Spanish government to push through economic reforms that might otherwise have been politically unpalatable amongst its heavily unionized workforce. Equally, Ireland and The Netherlands do to a lesser extent, have begun to bring down the burden of national debt which had accumulated over many years in order to qualify for stage III.

The Rush for Convergence[21]:

The Euro-enthusiasts agreed that the narrowing of inflations and budget deficits differentials should be engineered relatively quickly. Without this, the momentum for European integration might be lost. If the ECU were to be circulating throughout the EC countries in the last years of the 20th century this would be a major step forward n creating a European vision.In the words of the Madrid Council, the single currency would be an expression of the EC's "identity and unity".

The Maastricht Treaty demands that adherents to a single currency run economic and monitory policies that will lead European countries to prosperity anyway, with the added long-term bonus of a single currency if they succeed, but certainly no economic diaster if they do not.

Msastricht plays down four minimum conditions before currencies can join the Economic And Monetary Union[22]-

(A) Government must not live beyond their means. Government deficits must not exceed 3 percent of gross domestic product.

(B) Governments must not run up heavy debts Maastricht decrees that government debt must not exceed 60 per cent of GDP.

(C) Inflation must be kept at bay, and must not exceed 1.5 percent of the average inflation level prevailing in the three countries which are tacking inflation most

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21 Robert Minikun, "What was Agreed at Maastricht" in *The ERN explained* (London: Kogan Page), 1993, pp.45-46.

22 Leon Britain, "EMU's The end of a dream in EUROPE - The Europe We need", (Dartmouth: Aldershot), 1994, pp.55-59.

successfully. This ensures that as countries align the way they manage their economies they move gradually towards the inflation performance of the stronger economies.

(D) Likewise, long-term interest rates must not rise more than 2 per-cent above those in she three countries which have best managed to keep their interest rates down. This gives an indication of whether the markets believe that inflation rules will converge in future. If one currency requires higher long term interest rates than another, it is clear sign that higher inflation is expected in that country.

The underlying objective of the criteria is to draw economies closer together so that when they decide in favour of a single currency, they will be resilient enough to withstand it.

The importance of tackling debt, recognized in the 3 per cent and 60 percent target figures is significant, for governments and independent central banks have come to appreciate, just how much high debts can threaten currency stability.[23] There is even a strand of opinion which believes that these criteria could do more harm than good and they ask if it is sensible to stick to a 3 percent government deficit target deeming both the depths of recession and the peak of the economic cycle. The answer to this is yes as none would wish to create a permanently deflationary situation by sticking to such targets through thick and thin, for the Treaty explicitly states that if

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[23] David Buchan and Andrew Fisher, "Curbs on Capital central Controls will test Finance Ministers", *Financial Times* (London), 13 June 1985.

a member state exceeds the 3 percent government deficit criterion, the Commission shall prepare a report which will take into account "whether the government deficit exceeds governments investment expenditure" and take into accost all other relevant factors including the medium-turn economic and budgetary position of the member states.[24] There is nothing to prevent a short-term deficit exceeding 3 percent, provided that the economic reasoning underlying an increase over this medium-term target is sound.

The other criteria have attracted less attention because they are more obviously prerequisites of a single currency. In fact they may even surprise some people since they do not demand complete harmonization of interest rates and inflation, only their concentration in a narrow range.

There are strong reasons for believing that a period of budgetary retrenchment is required in the European countries concerned. Clearly fiscal retrenchment in Italy, for example is urgently required. But in the rush for convergence, national policy makers in the wake of Maastricht were set to act simultaneously to adopt more restrictive policies. When all these national decisions are aggregated, pan-European economic policy in the next five years looked set to dampen rather than promote economic growth. Given recent developments in Germany, it appeared that restrictive policies in the rest of Europe would coincide with a renewed tightening of German fiscal policy.

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[24] Mark Wise, Richard Gibb, "A Maastricht Milestone, en Route to European Union", in *Single Market to Social Europe* (London: Longman), 1993, pp.302-313.

The restructuring of public finances and reduction of inflation across Europe will no doubt provide a suitable backdrop for stronger economic growth over the long-term. The policy adjustments are thus rather like an investment with a short-term cost but long-term benefits.[25] It may well be agreed as fortuitous that the enthusiasm for pan-European monetary union towards the end of this decade had been dampened by certain EMS developments and just seven months after the ink had dried on the Maastricht Treaty, the Exchange Rate Mechanism was plunged into crisis.

The Crisis

In 1992 and 1993 the European monetary System was shaken by crisis so severe that to many they seemed to mark the end of the system and the end of the moves towards a monetary union in Europe for the time being. In the autumn of 1992 both the pound sterling and the lira were forced to withdraw from the system and float their currencies. In the summer of 1993, speculative attacks in the financial circles on the core, currency relationship of the French franc against the DM put such strains on the remains of the system and on the central Bank reserves that the basic 2.25 percent fluctuation margins had to be suspended completely and new fluctuations margins of .5 percent introduced, except for the DM and the Dutch Guilder, which retained the old margins. After fourteen fears the EMS was not clinically dead, but it was certainly in a state of suspended animation.

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[25] D. M. Harrision, "Economic and Monetary Union in the organisation of Europe", (London: Routledge), 1995, p.113.

Causes

There seem to be two main explanations as the causes of the crisis.[26] The first linked to the Maastricht Treaty itself. Contrary to the advice in the Delors Report, Maastricht deliberately set a series of political deadlines under which the EMS would evolve into an ever tighter monetary ensemble and then into a fixed exchange grate regime. Now in some respects this may have seemed a rational approach at the time that Maastricht was negotiated in 1991. The EMS had become increasingly stable in the 1980s and there had been no currency realignment since 1987. In addition, the setting of political deadlines in a Treaty was of course the standard device for moving the Community and its member states forward. However, this deliberate posting of the Community's intentions in the monetary sphere meant that the EMS no longer was seen as an end in itself. It became instead a means to a different end, economic and monetary union and as such its credibility became linked to the credibility of the latter

The second explanation is linked to the way in which the DM had become the core currency in the system. While this arrangement provided benefits to the other members in term of exporting German monetary virtues it did, of course also have the risk that any German momentary troubles would be exported too. The massive shocks to the German economy resulting from the unification of East and West Germany in 1990 were bound to produce shocks for the European economy as a whole. Specifically, the inflationary effects of German unification led the Bundesbank to raise German interest rates higher than they would have otherwise been simultaneously

26 ibid, pp. 113 to 115.

making the DM a more attractive currency to hold and forcing other European currencies linked through the EMS to raise their own interest rates to maintain the value of their own currencies.[27] This happens at a time when unlike in Germany, poor growth rate rather than inflation was the main problem. The basic (and growing) contradiction of this policy was the second element undermining the credibility of the EMS.

The two sets of quite exceptional circumstances seem to explain the general erosion of confidence by the financial markets in the official monetary policies of the member states in the period upto the crisis. The crises themselves were triggered by second-order questions i.e. the autumn 1992 crisis by unfounded fears that the French referendum on Maastricht would reject the Treaty, and the summer 1993 crisis by an unexpected decision by the Bundesbank not to cut a key monetary rate.

Conclusions[28]:

There was a resultant loss of credibility but the 15 percent fluctuation margin provided a cooling off period and member states were reluctant to divulge their positions as to their next move. Of what that could be gathered from the situation was that firstly, if the explanations of the background to the crises are correct, they may

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27 Alexander Italianer, "Mastering Maastricht : EMU Issues and How they were settled" in K. Gretschmann, ed. *Economic and Monetary Union Implications for National Policy Makers* (London: Allen and Unwin), 1994, p.5.

28 Emile Noel, "Reflections on the Maactrict Treaty", *Government and Opposition* (London), no.27, 1992, pp.148-157.

be time-limited in their effect. Maastricht is now ratified. The initial shock of German unification may be over or at least receding. There is of course another view that the system itself is flawed fundamentally and bound to fail because semi-fixed exchange rates cannot be reconciled with free capital movements and in fact exacerbate instability rather than reduce it by stopping the markets from gradually changing the value of a currency Secondly, it seems possible that the explicit visible political link between the EMS and EMU may have to be broken. A series of highly visible political deadlines leading up to the locking of parties and a single currency may only produce crises of confidence. Currency stability in Europe may have to be re-established as a good in its own right and any further steps towards locking national currencies may have to be taken on an opportunistic basic as market conditions allow as the Delors Report in fact implied.

Thirdly, perhaps too much confidence has been placed in the role of the DM in the system. While it is understandable that other member states might have wanted to import sound German monetary policies through membership of the EMS, there was always the risk that German monetary policy, although perfectly right for Germany would be wrong for another member state.[29] But the irony is that if the other member states want to pursue sound Monetary policies there is nothing to stop them from adopting Sound German monetary practices themselves and indeed, the move towards independent central banks envisaged in Maastricht may help them to

[29] D. M. Harrison, "Economic and monetary Union in the Organisation of Europe", (London: Routledge), 1995, p.115.

do so.

Fourthly, and finally, instead of seeing the EMS primarily as a means of importing monetary virtue it may be more productive to return to the original argument in favour of exchange rate stability in Europe.[30] One might observe, then, that the attempt to reintroduce "Breton Woods-style" exchange rate stability within the Community was always going to be problematic to the extent that a true common market between the member states did not exist and in fact does not yet exist. On the other hand, clearly economic integration in the community is deepening particularly through the progressive effects of the single market programme. With increased market integration the economic fundamentals which determine monetary conditions in each member state also increasingly converge.

This analysis seems to suggest two things. The first is that the search for exchange rate stability in Europe cannot be divorced from the fact of real economic integration exchange rate stability might be used as a tool to try to encourage economic integration. But if too much pressure is put upon it, it will snap as the EMS, when it tried to do too much. Yet, that experience in Europe suggests that the search for exchange rate stability in that zone remains a valid one so long as it proceeds hand in hand with that integration. The second is a separate but linked point. It is that-particularly as economic integration deepens-exchange rate devaluations aimed at obtaining a competitive advantage. Which are used as a deliberate tool of

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[30] Spaak Report, which served as the basis of common market (Brusels), para 74, 1956.

national economic policy, clearly can have no place. In a unified market the short-term advantages they confer on one country are offset by the disadvantages in another, which means that they undermine confidence in the entire market structure and in the long run, harm both. In the Europe-wide recession of 1993, for examples benefits for the whole European economy obtained by exporters in those countries whose currencies devalued in the crises of 1992 and 1993 'have been out-weighed by the negative economic impact of currency appreciation in Germany and in ERM members still linked to the D-Mark.[31] It is one thing to have to adjust the exchange rate because economic fundamentals are out of line with the rest of the market. It is another thing entirely for member states to reserve the right to adjust their exchange rate as they see fit in line with their own economic circumstances-and for each member state to fear that each other will exercise their right.

It is perhaps here that the case for action is the strongest as the single market deepens. What may be needed is a strengthening of the original EC Article 107 requirement that changes the exchange rates be considered as a matter of common concern. Perhaps the answer is linked to the general move towards independent central banks in the Community.[32]

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31 *Financial Times* (London), 15 December 1993.

32 John B. Goodman, "Monetary Sovereignty: The Politics of Central Banking in Western Europe", (New York: ST. Martins), 1992, p.7.

Chapter IV

THE OUTLOOK FOR A SINGLE CURRENCY

The launching of the 3rd stage of EMU and the introduction of the euro will represent a further step in the process of economic integration within the European Union. The effects will be felt primarily in the member states participating in the euro area. The conduct of a single monetary policy will by itself imply a regime change for these member states, but will also require enhanced co-ordination in other areas of economic policy.

Given the economic importance of the euro area whatever its initial size, the introduction of the euro will also have significant effects on member states of the European Union as well as outside it. These so called external aspects of the euro are the subject of increasing discussion in international fora. The OECD, the IMF and the Monetary committee have all devoted time to these external aspects.[1]

From the debate so far, of the likely impact of the euro on developments in the international economy and, more specifically, in the international monetary system, what emerges as the relevant analytical framework is fairly straightforward. Nevertheless, exact quantification of these effects will not be possible. Firstly, many of the effects will be felt only gradually and will depend upon private sector expectation, while other effects will already be felt before the euro is introduced.

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1. Commission of the European Communities, "External Aspects of Economic and Monetary Union", *Commission Staff Working Paper*, (Brussels) 23 April 1997, Sect (97), p.803.

Secondly, some of the effects will work in opposite direction. Thus, for example, evolution of the euro exchange rate relative to other international currencies cannot be determined *ex ante*. Thirdly by definition, the external effects of the euro will not only depend upon the economic policies and performance in the euro area but also on those of partner countries. Nevertheless, it is clear that a smoothly functioning EMU will be of paramount importance in assuring that the external effects of the euro are beneficial.

Why does Europe need a Single currency?

The single currency will mean a fundamental and unprecedented upheaval for Europe's citizens and business. So one must not lose sight of why is it being done.[2] The single currency will bring the citizens of Europe:

- a more efficient single market. For the single market to work smoothly, exchange rate adjustments must not be allowed to disrupt trade or investment.
- stimulation of growth and employment The single currency will be based on sound economic foundations. In addition, the price stability objective of the independent European Central Bank which combines greater integration of financial markets, may yield better borrowing conditions;
- the end of the costs of convert one currency into another within the Euro-area.
- greater international stability. The EU is world's leading trading power. Its

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[2] M.Y. Yves - Thibault de SILGUY, "Towards a Single European Currency - An Intervention", (London: Chatham House), 30 October 1995.

currency will naturally become one of the main exchange and reserve currencies, on an equal footing with the dollar or the yen.

- enhanced monetary stability.[3] With capital moving freely between interdependent economies an autonomous national monetary policy is not a realistic option. By collective management of a single monetary policy, Europe's central banks would have a shared but effective responsibility over one of the best and strongest currencies in the world.
- simplification of the everyday lives of Europe's citizens as they travel and make purchases in other members states. Thus with the single currency, travel and tourism will be easier and less costly.
- reduced costs for the companies as the companies will no longer need to bear the cost of maintaining stocks of cash in numerous different currency accounts.
- Finally, Europe's exporters will have a stable alternative to the dollar or the yen as it is much easier if one can invoice in one's own currency.

Politics of the Monetary Union

The 1992 currency crisis represented a threat to the European approach to foreign exchange management, but also an opportunity. The threat was clear, as the crisis had dark historical parallels. Massive international capital flows swept away central bank attempts to contain downward pressure on the lira and sterling, making

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3 European Commission, "Green Paper on introducing the Single Currency", (Brussels), 31 May 1995.

even an orderly realignment defficient. The disarray in the currency markets was likened by a veteran German Central Banker to the final days of the Bretton Woods system. The eventual temporary suspension of the two currencies was also reminiscent of the ill-fated 1970s 'Snake' of European currencies, which France left, rejoined and then abandoned for good.[4] If the crisis was simply the product of an irrational herd instinct in the currency markets, then "Only dealers won in Lira Support".[5] But the General opinion was that the currency pressures were symptoms of underlying economic divergence, which the Exchange Rate Mechanism after Maastricht was ill-placed to resist. But the opportunity lies in the future- using the lessons of this crisis to help shape a more appropriate approach to currency management for Europe in the 1990s.

Political confidence in the EC institutions and the path towards monetary union are closely intertwined. At the outset, the European Central Bank and an ECU area must not be created as an initial, short-lived experiment in powerful European institutions. There are three political concepts which will bear directly on the ECU's fate and which may be kept in mind They are[6]:

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4 Robert Minikeir, "Unpredictable Times - The Future and the Financial markets", in *THE ERM EXPLAINED* (London: Kogan Page), 1993, pp.157-159.

5 Financial Times, (London), 23 June 1993.

6 Jan-Erik Lane and Svante, Ersson, "Convergence Versus Divergence in European Politics: An Introduction", (London: Sage), 1996, pp.1-13.

- subsidiarity;
- a multi-speed Europe;
- a Europe of multi-dimensional integration.

Subsidiarity: The increased significance of "subsidiarity" for Europe will tend to postpone the broad application of the final stages of monetary union. The European-Monetary System with occasional realignments devolves control over monetary policy to the lowest level (the national central banks) while facilitating a pan-European approach to management of currency fluctuations. However, for the countries faced with a high degree of economic inter-dependence at the core of Europe, this is clearly insufficient. Even in the light of subsidiarity, there are strong grounds for arguing that a mini-EMU Central Bank is required. Only in this way will the concerns of the smaller economies be reflected in the single currency area's monetary policy.

The Multi-Speed Europe: The concept of a Two-Speed: Europe may already be out-dated just as it is being advanced as a solution to the problems posed by the ERM crisis. The accession of Greece, Spain and Portugals had already contributed considerably to the diversity of the community and special arrangements have allowed them to adjust slowly in certain areas to pan-European norms. The pean to broaden membership further not just to the EFTA Countries but Eastern Europe will no doubt mean additional 'speeds' in Community harmonization.[7] A multi-speed approach to

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[7] ibid, no.4, p.160.

monetary union thus lies within the general direction of Community developments rather than leading a new and potentially hazardous way forward.

A Europe of Multi-dimensional integration: The scope of Community issues is gradually widening as the European Economic Community develops into a deeper "European Union". The Maastricht Treaty lays the foundation for increased co-operation in social policy and defence issues. This broadening came at the cost of diluting the assumption that, whatever speed individual Member States were proceeding at, they were all heading for the same objective. The accommodation of the community to the concerns of the Danish people at the Edinburg Summit also suggests that increased flexibility will be allowed for individual Member States. Each states integration with the community will be mapped out across several dimensions and monetary union will only be one of these.

Economics of the Monetary Union

Overlaid on the political backdrop is the 'economic logic' of adopting the ECU. It seems quite logical that major economic benefits are to be had from reducing barriers to trade and mobility neither the Community and just not creating a single currency area.[8] Only very volatile exchange rates (adjusted for inflation) dampen

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8 Willem Molle, "Estabilisation Towards a Monetary Union", in *The Economics of European Integration Theory, Practice*, (Dartmouth: Aldershot), 1996, pp.389-417.

trade. Substantial progress has already been made in implementing the Community Directives to create a Single Market, but start-1993 represents a staging post in this process, not the final destination. The additional steps are likely to be increasingly politically sensitive for the Community members states and require lengthy negotiations. With much of the single market task ahead of European governments, not behind them, the economics of the situation point to greater emphasis on a deepening of trade integration over the next five years rather than a major revolution in European monetary institutions.

Exchange rates are not just a barometer of prudence in economic policy with short terms stability against the Deutschemark, as some sort of holy grail. Currency pressures reflect shocks to individual Member States (such as German reunification) and changes in the exchange rate can act as a 'safety valve' until wages and other domestic prices adjust.[9] Countries built on federal structure (such as the United States) can do without the safety valve but federal budget transfers cushion the blows to individual states. Over the next five years, Europe is unlikely to have the federal budget, the labour mobility or the wage flexibility to adopt the ECU as a pan-European currency. But there are substantial differences in the extent of economic integration and in the likelihood of country-specific shocks for the individual community economies. The economic logic points to a multi-tier approach to monetary union, with a core of closely linked economies at the centre.

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[9] ibid.

The European Monetary System was set up very much as the *modus operandi* of day to day currency management. Its major institutional innovations related to intervention finance and the framework for agreeing realignments. But the Maastricht treaty gave a new gloss to the ERM, suggesting that devaluations should become increasingly infrequent as the establishment of the single currency areas is approached.[10]

Anchoring exchange rates and foregoing realignments represents very much a' rule-based' approach to economic policy coordination, one in which monetary policy autonomy inevitably migrates from the weak currency to the hard currency central banks. It is the Bundes bank which in the end is primarily determining inflation in the ECU currency bloc.[11] The policy tensions between the United Kingdom and Germany ahead of Sterling's departure from the system are thus inherent in the post - Maastricht operation of the system.

Destination Euro - Developments in 1995-96

The most concrete initiative in the 1991 Maastricht Treaty was a fresh attempt to build economic and monetary union on the EMS foundations. According to the

10 Uncertainty in exchange rates has an influence on both imports (sudden increases in production cost through intermediate goods) and exports (sudden fail in country's competitiveness when its own currency appreciates (De Lattre, 1988).

11 Robert Minikein, "The Economics of European Union", in *The ERM explained*, (London: Kogan Page), 1993, pp.161-163.

Maastricht blueprint, the transition to the third stage of economic and monetary union - with a European central bank taking over management of a common monetary policy and eventually a single currency - should take place by 1999. The proposal for the earlier inception of single currency (in 1997) though stands shelved but the developments in 1995-96 deserve proper scrutiny:[12]

Renewed Turmoil in the EMS: January 1995 saw the entry into the ERM fold of Austria, whose shilling had for many years informally shadowed the Deutschmark. But it also brought renewed turbulence on the exchange markets, as nervous investors pulled out of Italy, Spain and Sweden in the wake of Mexico's sudden financial crisis. In early March, Spain devalued the peseta by 7 %, followed grudgingly by Portugal with a 3.5% drop in the excudo.[13]

The French franc came under fire repeatedly during the year, reflecting political uncertainties in the run-up to the May presidential election and subsequent misgivings about the new French administration's commitment to EMU. Meanwhile the pound sterling, lira and Krona, free of ERM constraints, sank to record lows against the D- Mark during the spring of 1995, although by early 1996 all but sterling had recovered appreciably.

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12 EIU European Policy Analyst, "Critical Issue: The Single Currency", (Brussels), 3rd quarter 1996, pp 83-87.

13 Official Publications of the European Communities, "The Community Budget: The Facts and Figures" (Luxembourg), 1996.

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13 Official Publications of the European Communities, "The Community Budget: The Facts and Figures" (Luxembourg), 1996.

The 1997 option is dropped: In June 1995, EU finance ministers abandoned the first target date for launching EMU in 1997 conceding that it would be impossible to assemble a majority of eight member states that would both meet the Maastricht convergence criteria by the end of 1996 and be willing to join.

Sweden claims an opt-Out: When presenting its convergence programme to EU finance ministers in September, Sweden surprised its partners by declaring that, even if it met the budgetary and other criteria, it would not make the final move to the single currency before the Riksdag gave its approval. Sweden's participation would also be the subject of a popular referendum.

Born raises the hurdles: In an effort to appease growing popular and political opposition to abandoning the D-Mark for a possibly-inferior Euro currency, German Finance Minister Theo Waigel came up in November with the idea of a "stability pact" that would bind EMU participants to strict fiscal rectitude. He suggested that the club members should aim over the medium term to limit their budget deficits to just 1% of GDP in "normal" times; that the 3% ceiling should not be exceeded even in times of economic difficulty and that transgressors should face automatic sanctions in the form of interest free deposits and eventual fines amounting to 0.25% of GDP for each percentage point of excess deficit.[14]

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[14] EIU European policy analyst, "Fiscal Issues: The Single Currency" (Brussels), 3rd quarter 1996. p.85.

Madrid summit agrees a transection Plan: Averting their gaze from the ominous event in France - where planned welfare cuts had provoked a wave of labour unrest- and brushing aside growing doubts over the feasibility of even the 1999 deadline for EMU, European heads of govt. gathered in Madrid in December 1995 to formally endorse a transition plan drawn up by the European Monetary Institute (EMI) (precursor to the European Central Bank) and finance ministers and to finally settle on a name for the single currency. While the Maastricht treaty refers to the ECU, this name was dumped on the grounds that Germans associate it with the European currency unit, the basket currency which since 1979 has depreciated steadily against the D-Mark. Instead the choice fell on the uninspiring 'euro'. The existing ECU will be swapped one-for-one for the new currency when it appears.

According to the timetable endorsed in Madrid, the decision on moving to a single currency will be taken" as early as possible" in 1998, on the basis of firm data for economic performance in 1997. Exchange rates will be irrevocably locked from 1 January 1999 onwards. From that date monetary policy will be landed over to the new European central bank and forex operations will take place in euro, as will the issue of new public debt. Three years later, national currencies will be phased out as euro notes and coins come into circulation during the first six months of 2002. All cheques transfers and credit cards will be converted into euros. The change over will be completed by 1 July 2002 when national bank note and coins will no longer be legal tender.

Selling the euro: Not least of the challenges facing proponents of monetary union is to convince ordinary citizens that a single currency is in their interests. Thus for governments in France and elsewhere have invoked the need to meet the convergence criteria as a justification for austerity measures, with the result that many people have come to associate EMU with unemployment.[15] There is thus a danger of a popular backlash similar to that which nearly scuppered the Maastricht treaty. During 1996 work has begun on a major information campaign at Union and national levels in an effort to present EMU in a more positive light, and to help businesses and consumers prepare for the changeover to a common currency. The sales drive kicked off in January with a two-day rally in Brussels.

ERM mark II : A key issue that was to be worked on was the relationship between countries participating in the single currency bloc and those remaining outside. An informal meeting of EU finance ministers and central bankers in Verona in April reached a consensus on the need for a revised exchange rate mechanism (ERM) to link the 'ins' and 'outs' and prevent so-called competitive devaluations by the latter[16] There was an agreement that ERM II would need to remain flexible, with relatively wide fluctuations margins around the central rates as at present.

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[15] World Bank, World Development Report, (Washington DC), 1996.

[16] European Commission, "Reinforced Economic Convergence Procedures" (Brussels), 16 October 1996.

Some details were filled in at the Ecogin Council in June 1995. The new mechanism, to be introduced from the start of 1999, will be based on central rates against the euro, rather than a basket of currencies. Both the European and national central bank could intervene to support a currency under pressure, but would not be obliged to do so if this conflicted with the goal of maintaining price stability. Ministers did not reach a consensus on whether countries should be required to participate in the existing ERM if they want to join EMU in 1999. This issue is likely to remain moot until the last minute; meanwhile Italy and Finland were expected to join the ERM, but the preceding UK government expressed its firm oppositions to it.

Stability pact: EU Finance ministers at Verona in 1995 also discussed the German idea of a stability pact to ensure ongoing budgetary discipline among the successful EMU members after 1999. It was agreed in principle that the Maastricht target of 3% of GDP for budget deficits should be seen as a ceiling and that eventually deficits should be reduced to zero.[17] The idea of mandatory sanctions, beyond those foreseen in the treaty, on the other hand was resisted. In June the ministers agreed to explore how secondary legislation could be used to ensure that member states fiscal policies are effectively coordinated. The central element will be the "excessive deficit procedure" set out in the Maastricht treaty, which provides that countries joining EMU must ensure that their budget deficit does not exceed the 3 % limit during a

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[17] Richard GIBB, "A Maastricht Milestone En Route To European Union in Single Market to Social Europe", (London: Longman), 1993, pp.303-315.

normal business cycle. Where an excessive deficit persists, a qualified majority of member states can require a government to take particular action to redress the situation within a given time limit and impose fines if it fails to comply.

Among the issues still to be settled were, what would amount to the "temporary" and "exceptional" circumstances in which the treaty allows the ceiling to be breached and the size of the fines.[18] Over the coming months, the Council was to look for ways to tighten up the deficit procedure, by shortening deadlines and ensuring effective sanctions against fiscal irresponsibility. But Germany's demand for automatic penalties when a deficit exceeds 3 % is unlikely to be met.

Heading off speculation: The Commission and the European Monetary Institute were also to look into ways of forestalling currency speculation during the run-up to the launch of monetary union and in the subsequent transition period. The EMI president, Alexander Lamfalussy, was of the view that the exchange rates at which EMU participating currencies will be linked to the euro should be announced in advance. For example, use of the average exchange rate over 1996-98, perhaps with a heavier premium to the 1996-97 levels would limit the room for speculation.

A more controversial idea is that, during the transition period, contracts that do not respect the EMU members official exchange rates vis-a-vis the euro should be

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18 Roy Pryce, "The Treaty Negotiations", in A. Duff, J. Pinder and R. Pryce ed., *Maastricht and Beyond*, (London: Routledge), 1994, pp.129-138.

legally unenforceable.[19] But critics believe that such a measure would simply drive speculative trading to non-EU markets. Another possibility suggested by the European Commission is that during the transition period debts should be repayable in either euro or the national currency, at the debtor's choice, thus eliminating any exchange gains or losses.

EMU Progress Report Card: In May, the Commission issued its annual evaluation of member states progress on economic convergence towards the Maastricht criterion While 11 of the Union's 15 countries now meet the inflation criterion all but three - Denmark, Ireland and Luxembourg - flunked the fiscal tests in 1995, and the current economic slowdown augers no improvement in 1996. Nonetheless, the Commission's optimistic forecasts show seven countries - Germany, France, the Benelux, Ireland and Finland - meeting the 3% deficit criterion by 1997, with Austria and Sweden coming close.[20] This represented an exercise in exhortation - as much as prediction. Finance Ministers in July approved tough recommendations to the 12 fiscal defaulters to tighter their belts further in 1997 in order to meet the deficit and debt criteria.[21]

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19 Gilles Saint Paul, "Exploring the Political Economy of Labour Market Institutions", *Economic Policy*, (London), October 1996.

20 Jeanne-May Seen and Jacques Peekmaus, "Regulatory Competition in the Single Market", *Journal of Common Market Studies* (Oxford), vol.13, March 1996, p.84.

21 "Divisions in Dublin", *Analyst* (New York), February 1996.

Decisions in Dublin (December 1995): A top priority of the Irish presidency was to push ahead with the preparations for introduction of single currency. By the Dublin summit in December 1995 following proposals were affirmed

- the new exchange rate mechanism
- the proposed stability pact
- technical legislation on the single currency; and
- selection of designs for euro notes/coins

Preparing for stage 3 of European Monetary Union[22]

In a recently published document (24/96), the European Commission gives an overview of the progress so far made in the preparatory work for stage 3 of the EMU leading to the final shift to a single currency and lays out a summary of the economic situations and progress in achieving convergence as well as relations between the Euro area and the countries not initially taking part in the single currency, the legal status of the Euro and communications.

According to the Commission, convergence is making headway as regards inflation, long term interest rates and public deficit. The average inflation rate in the European Union has plummeted to a historic low at less than 3 percent, with ten member states meeting the corresponding convergence criterion. Member states are also making sustained efforts to control their deficits. However, only three countries

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[22] Delegation of the European Commission in India Information Services, "Preparing for stage 3", (Brussels), 25 July 1996.

Denmark, Ireland and Luxembourg, are not currently running an excessive deficit.[23] The Commission is confident that there will be a significant number of Member States capable of meeting the necessary criteria for moving to stage 3 when final decisions will have to be taken by the European Council in early 1998 on the basis of the definitive data for 1997.

Adequate progress has been made in defining a new monetary relationship between EMU members and non-member states. By now a broad consensus has been arrived that the new monetary relationships would be based on an exchange rate arrangement linking the currencies of the non-EMU member states to the Euro.[24] The Euro will be the anchor currency of the new arrangement with the onus of adjustment being primarily on countries not in the Euro Zone. It is also pointed out that in order to overcome differences in convergence among Member States and to minimise the risk of market speculation, the new arrangement will need to be flexible - allowing for sufficiently wide fluctuation margins around central parities. In regard to the legal framework for the use of the Euro, the Commission says that legal certainty must be established well in advance of the introduction of the new currency. Technical preparatory work on a Council regulation is currently under way with a view to ensuring legally enforceable equivalence between the Euro and the national

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23 ibid.

24 Christopher Taylor, "EMU: 2000", in *The Prospects for European Monetary Union*, The Royal Institute of International Affairs, (London), 1995, pp.201-211.

currencies. A working document on a draft text prepared by the Commission emphasizes on:[25]

- that the Euro is to be the single currency of EMU member states, with the Euro being divided, during the transitional phase (1 Jan 1999 until 30 June 2002), into the national currency units, thus ensuring a legally enforceable equivalence between the Euro and the national currency units.
- confirming uninterrupted the continuity of contracts denominated in national currencies and in the ECU basket
- rules on legal tender and rounding

For further promoting public awareness of the Euro, the European Commission has published a communication plan which is based on three main guiding principles: decentralisation and consistency, partnership with national and regional administrations and institutions and progressive implementation of the programme and policies; Reinforced economic convergence Procedures and a new Exchange Rate Mechanism.[26]

The European Commission on 16 October 1996, submitted a communication to the Council on reinforced convergence procedures and a new exchange rate

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[25] Delegation of the European-Commission in India information service, ibid, n.22.

[26] European Commission, "Reinforced economic convergence procedures and a new Exchange Rate Mechanism", (Brussels), 16 October 1996.

mechanism. Presented at the initiative of President Gauchos Santer and Yves-Thibault de Silguy, Commissioner responsible for economic, monetary and financial affairs, the communication reiterates the main features of the ERM-2 discussed at the informal meeting of Finance Ministers and Central Bank Governors on 21 September 1996 and suggests a number of ways of reinforcing existing convergence programmes and procedures. Especially, the presentation of more detailed national convergence programmes may help reduce the causes of monetary instability (divergent inflation and public finance policies) in the European Single Market (ESM) and allow non-member states to join the euro-zone as soon as possible. Exchange rate stability between the euro and currencies of the non-member states of the monetary union from the start (the "pre-ins") is vitally necessary for the smooth operation of the internal market because the whole idea is that the introduction of the euro on 1 January 1999 must not split the EU into two.

The ERM will be a temporary waiting room for countries preparing to join the EMU.[27] In accord with the recommendations of the European Monetary Institute (EMI) there is a broad consensus among Member States on a "hub and spoke" arrangement of bilateral links between the euro and the pre-in currencies. The fluctuation margins may be relatively wide, with the possibility of closer links for countries with sufficiently strong convergence fulfilment; intervention by the European Central Bank would be automatic at the margin of the fluctuation bands. It may, however, be suspended where the level of interventions is incompatible with a

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[27] iIbid.

monetary policy geared towards price stability.

Experience bears evidence that sound economic management by all member states is the key to exchange rate stability. Monetary turbulence is often due to divergent rates of inflation and poor control of public finances. Tackling these divergences is also the priority to bring countries in line with the convergence criteria for participation in the EMU. As such, the success of the ERM-2 is clearly linked with reinforced convergence efforts.

Reinforced convergence efforts[28]

Given that convergence is the pre-requisite for exchange rate stability, the Commission envisages a role for reinforced convergence programmes in the management of the new ERM. Based on the existing procedures for the evaluation of national convergence programmes and multilateral surveillance of economic policies (under Art 103 of the Treaty), the Commission makes the following propositions:

- all pre-ins would be formally obliged to submit there convergence programmes.
- the first programmes in this new grouping would be submitted before 1 January 1999
- they would be updated annually
- convergence programmes would contain greater detail than at present, particularly on the measures envisaged to achieve the convergence goal in

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[28] ibid.

terms of public finances, inflation and exchange rate stability. They might also contain indications of the subsequent action envisaged to correct any slippage from agreed targets.

- a more precise time table may be set for the examination of national programmes by the Council.
- the Council would have the right to endorse a country's convergence programme after detailed examination and analysis by the commission and the Monetary Committee (which will be succeeded by the economic and Financial Committee on 1 January 1999).[29]
- the Council would exploit to the full the procedures of Article 103 of the Treaty, in particular the possibility to make policy recommendations (if appropriate publicly) to countries whose economic performance falls short of the agreed objectives.

The underlying philosophy of these new arrangements is to create a mutual commitment: a commitment by the pre-in country to proceed quickly towards participation in the euro and a commitment by other Member States to support its efforts.

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29 Ferdinando Riccardi, "A Look Behind the News, Europe-Hebdo Overseas Selection", no.1827, 2 June 1997.

The rationale for reinforcing convergence criteria stems primarily from the fear that excessive deficits in a member of the EMU may bear negative effects for others.[30] For instance, they could be the source of financial instability or even an unsustainable pace of debt accumulation resulting in a solvency crisis, possibly leading to the violation of the "no bailout clause. This would shift the burden onto other Governments and necessitate considerable monetary expansion, thus creating "moral hazard". Like-wise an increase in government borrowing could push out private investment elsewhere in the Community, or the emergence of large budget deficits within the EU could lead to exchange rate and payments problem vis-a-vis the rest of the world. More generally, a common monetary policy could conflict with independent national budgetary policies unless the latter were coordinated and their consistency with monetary policy ensured. The whole exercise seems to assume that Governments have an inherent tendency towards excessive deficits and that explicit constraints on fiscal policy are needed to check this tendency and to attain the requisite degree of coordination and consistency. Most of the problems stem from the divergence of a single country from the norm. They may be less important if all the members states fall short of the norm to an equal degree.

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[30] European Commission, "Deficits and Deflation in Industrialized Countries" *Trade and Development Report* (Luxembourg), 1993. p.83.

Implications of the Euro for the World Monetary Relations[31]

As the deadline for the introduction of the euro approaches, there is increasing interest in the effect of EMU beyond the frontiers of the European Union. This trend is particularly evident as the euro gains importance on the agenda of international economic debate. The Commission's working document dated 23 April 1997, presented by President Gauchos Santer and Yves Thibault de SILGUY, Commissioner responsible for economic, monetary and financial affairs, is intended as a first tangible contribution to this debate from the Commission. The document provides a preliminary analysis of economic and institutional consequences of the introduction of the Euro as an international currency alongside the dollar and the Yen. With the Euro, Europe will have a presence on the international monetary scene which better signifies Europe's economic and commercial weight. This will progressively lead to more balanced international monetary relations and should make companies in the euro zone less vulnerable to external developments. It also looks at the probable use of the euro for central bank reserves, pricing in international trade and in the composition of investment portfolios. Further, the document concludes that, although there is likely to be a progressive shift towards greater use of the Euro, this is unlikely to incite significant exchange rate movements when the euro is introduced. The

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[31] Commission of the European Communities, "External Aspects of Economic and Monetary Union", *Commission Staff Working Paper* (Brussels), 23 July 1997, sec.(97), p.803.

institutional implications for the global monetary system are examined:[32]

The Euro zone - an economic entity on the scale of the US

The Euro zone (assuming it rapidly extends to cover all the 15 member states) will be comparable with the economic and commercial weight of the US and will be greater than the Japanese economy. In 1996, the EU accounted for 38.3% of the GDP of the OECD countries against 32.5% for the US and 20% for Japan. European Monetary union will mean that Europe has a domestic financial market which corresponds to its huge economic and commercial presence globally. For instance, the conversion of sovereign debt into Euros will create a single market in which the bonds issued by different national authorities are virtually interchangeable, the residual regulatory and credit risks being minimal. The Euro-dominated market will therefore rapidly become one of the largest world markets.

Less vulnerable to the effects of world currency Fluctuations:

The economics of Europe are today heavily influenced by developments of international exchange markets. The tensions within the ERM in spring 1995 were a clear example of how international developments may affect the smooth functioning of the internal market. This is so because a large proportion of economic activity in Europe has been tied up with international trade and therefore depends on unpredictable exchange rate movements elsewhere. With the Euro, the degree of

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32 ibid.

openess of the European economy would come down to about 10% in accord with the main trading partners - US and Japan, Europe's companies will thus be less affected by exchange rate movements on world markets.[33]

Gradual decline in the dollar's dominant international position

Although the dollar is clearly the world's leading currency (used for 50% of commercial transactions and over 80% of financial market transactions), its dominant position has been declining since the early 1980s, particularly in favour of the DM and the Yen. the introduction of the Euro (and the associated extra depth and the liquidity of European financial markets) would tend to intensify this movement.[34]

- Commercial transactions - the Euro will provide an attractive alternative to the dollar for trade with countries with close monetary economic and geographical links with the European Union.
- Central Bank reserves - the strong anti-inflationary credentials of the Euro assured by the independent European Central Bank and the existence of large and liquid euro-denominated markets will make the Euro attractive as a reserve currency.
- Portfolio holdings- it is difficult to forecast the composition of private

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33 Ruairi Quinn, "The Euro is Coming to Your Pocket", *Business Post* (London), December 1996, p.19.

34 Sir Leon Brittan, Vice President of the European Commission, "EMU-Why its right to bide our time", His speech at leeds on 18 October 1996.

investment portfolios. However, there is already a move away from the dollar. Between 1981 and 1995 the proportion of world savings held in European currencies has increased from 13 % to 37 %, while the share of the dollar has fallen from 67 % to about 40 %. This trend is likely to continue with the introduction of the Euro.

No abrupt impact on exchange rates:[35]

The document assesses the possible market impact of the transition to the Euro and concludes that unwelcome excessive exchange movements may have to be avoided Exchange rates are not set by decree, but rather by the markets appreciation of a range of economic and other factors. However, the following factors suggest that the transactions may be smooth:

- countries participating in the Euro zone will have sound economic policies because of the application of the convergence criteria and the stability and growth pact devised to ensure lasting budgetary discipline.
- even if central banks of participating countries have more reserves than they need in dollars, they are unlikely to sell them too rapidly to avoid undermining market confidence.
- private investors are likely to react in different ways according to their specific situations. Some will be attracted to the Euro as a credible alternative to the

[35] Commission Staff Working paper, Commission of the European communities, ibid, n.31.

dollar. But others may seek to compensate from the reduced scope for diversification within Europe and therefore extend their holdings in non-European currencies.

Based on sound economic principles and a credible anti-inflationary institutional framework, the Euro will be a factor of greater stability in the international monetary system.

An opportunity for closer international macro - economic cooperation:[36]

The Euro will open the way for closer international economic and monetary surveillance and co-ordination in the interest of achieving greater exchange rate stability. In this the responsibilities of the Council of Ministers, the European Central Bank and the Commission in the various possible forms of exchange rate relations between the euro and the currencies of the third country, become very important.

In conclusion it may be said that the present system of managed floating exchange rates is likely to continue after the introduction of the Euro. However, a number of questions are identified, in particular about the way a single external exchange rate policy should be defined. The consequences for existing international fora such as the IMF and the G7 also need careful consideration and need to be addressed rapidly to ensure that the necessary decisions are taken before the start of

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[36] Jacques Santer, President of the European Commission, "Europe's economic challenges and the role for the euro", His speech at the UNO-New Euro-Symposium (Wassenaar), 15 April 1996.

stage-3 of the EMU on 1 January 1999.[37]

EMU 1999-A tryst with destiny

The theory of EMU is relatively simple. On 1 January 1999 those EU countries which have met the convergence criteria will have their currency exchange rates irrevocably fixed. Individual currencies will then be replaced with a new single currency called the 'Euro'. Thus once EMU happens, participating currencies will have one currency one monetary policy and one interest rate. Most importantly, a series of monetary and fiscal disciplinary measures may have to be taken by all member states before they participate in the EMU. Secondly, countries willing to join the EMU must have been part of the Exchange Rate Mechanism for a period of at least two years before the Union. While the countries do not seem to have any problems achieving the monetary criteria, only tiny Luxembourg[38] has satisfied the stringent fiscal criteria. European countries need to eschew their traditional penchant for massive social security budgets and let economic imperatives dictate political expediency.

Ironically, Germany which has been the strongest advocate of the stability part and strict penalties is itself doubtful of meeting the convergence criteria. The stability

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37 ibid, n.36.

38 EMU- "Europe's Tryst with destiny", *European Policy Analyst* (London), February 1997, p.29.

pact signed at the Dublin Summit in December 1996 lays down the penal measures to be imposed on countries which fail to adhere to these limits.

The analysis of the feasibility of a country joining the EMU is based on the yield spread of bonds denominated in a particular currency over the bonds denominated in Deutschemark.[39] The rationale is that with the inception of the, EMU there will be only one currency, the yield on various bonds will have a tendency to converge towards the yields on the strongest currency in the Union i.e. the DM. This is so because the yield curves for national currency bonds issued by the governments of, such as Germany and France will be indistinguishable from each other if both are to be part of the EMU and share a common currency. Comparing the yield spreads over a two month period, it becomes apparent that Austria, Belgium, France, Finland, Ireland the Netherlands have very low yield spreads of 0 to 1 percent and these spreads have been closing in over the past two months.[40] These would perhaps constitute the core group which will initially participate in the European Monetary Union (EMU). Denmark, Sweden and UK appear to be the most likely non-starters with yield spreads constant over the said period. Italy, Spain and Portugal have seen their yield spreads narrowing substantially but fundamental factors like high budget deficits and high interest rates pose a major question mark on their ability to

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[39] Jacek Saryusz - Wolski (1994), "The Reintegration of the "Old continent". Avoiding the costs of "Half Europe" in S. Bulmer and A. Scott ed., *Economic and Political Integration of Europe: International Dynamics and Global Context*, (Oxford: Blackusey), 1994, pp.190-209.

[40] ibid.

participate in the EMU in 1999. But these countries could as well prove to be the proverbial dark horses in the race towards a single currency. Greece with a budget deficit of over 9 percent of GDP, double digit inflation and steep interest rates of 16 percent is perhaps the only country which is not even in the reckoning to participate in the EMU in the near future.

Though the final decision-on the qualifiers will be out in mid - 1998, speculation is rife on who is willing and in a position to make the grade.[41] The British with their traditional skepticism about an economic and monetary union are most likely to stay out of the single currency. Greece is unlikely to make it in this century and Italy notwithstanding its budgetary amends, is long away from meeting the convergence criteria. The Danes have opted not to participate in the single currency and the Swedes with a bloated budget deficit at 7.3 percent of GDP and the need for a referendum seem to be doubtful starters. Portugal and Spain seem to be off the mark even in meeting the monetary criteria, leaving aside the fiscal criteria.[42] Austria, Finland and Ireland may just about make it if they keep their fiscal and monetary situations under tight control. So, that leaves a core group consisting of France, Germany and three Benelux countries who are most likely to qualify for the European Economic and Honetary Union (EMU). Recently, Germany whose

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[41] Fritz Scharpf, Negative and Positive Integretion in the Pol. Economy of European Welfare States, Jean Monnet Chair Papers, Robert Schuman Centre, European University Institute San Domenico 1996, pp.88-93.

[42] ibid.

candidacy for the EMU was never in doubt, has been reporting budget deficits of around 4 percent of GDP and the GDP growth has been falling. However in its projections for the next two years, the German budget envisages a deficit of around 2.5 percent to account for lower growth rates. Experts believe that considering the pivotal role that Germany has played in the unification process, there is no way it can afford not to be the founding member of the EMU in 1999.[43]

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[43] EMU - ibid, n.38, pp.29-31.

Chapter V

CONCLUSION

Integration has made considerable progress in Europe in the post-war years. That is evidenced by many indicators: economic ones, such as the interpenetration of markets and the convergence of price indices, and policy ones, such as the fields covered, and the strength of instruments used by EU institutions. Newer objectives have been set for future economic integration. After the completion of the internal market, the most important goal will be the gradual build-up of the Economic and Monetary Union. The emergence of a European Union in which increased solidarity leads to considerably more international redistribution and social cohesion seems to be somewhat farther down the road.

The progress along the road from free trade area to full union passes through Economic and Monetary Union (EMU). Such a union on the monetary side implies, either full and irrevocable convertibility of all currencies, coupled with a system of fixed parities between the participating currencies, or a single currency. The policy of integration needed for a monetary union has mostly to do with stabilisation. Stabilisation policies are pursued because adaptation to new currencies entails costs which are sometimes considerable. The purpose of stabilisation policies is to cushion the effects of internal and external trauma to the economy.

The stabilisation of exchange rates will be an important target for the 1990s. The arguments for a Monetary Union in Europe are very strong and the main advantages for the private sector are the lowering of transaction costs, the taking away of exchange rates uncertainty and the avoidance of distortions of competitive situations that are due to changes in exchange rates triggered by financial operations but lot justified by economic fundamentals. For the public sector, better for the economy as a whole, the advantage is that the Monetary Union precludes competitive devaluations that in the long term have as their only effect that inflation increases, and it affects monetary reserves. The disadvantages are loss of room for manoeuvring for the macro policies of member countries. On balances the advantages outweigh the disadvantages, and so the EU will continue its efforts to reach its target, the EMU.

The Maastricht Treaty defines the time scale and the route to reach that target. The EU may, however, have to adopt a different road, as the one laid down in the Maastricht Treaty may be too problematic in an environment characterised by full freedom of capital movements, economic restructuring and continuous divergence of inflationary pressure.

Two Apprehensions

Associated with the ongoing processes are the fears of Germany's over bearing role in the scheme of things often characterized as Germanization of Europe and secondly that if the EMU would spell the end of independent national monetary policies.

As regards the first apprehension it can be said that the technical wording of the Maastricht Treaty provisions on Economic and Monetary Union (EMU) conceals the intense politics that preceded its enactment. In other words, the EU treaty was the result of intense negotiations and its story is one of bargaining and compromise. Yet there is no doubt that the EMU envisioned by the Maastricht Treaty has a German face. Like the Bundesbank, the proposed European Central Bank would have a federal structure and would be independent of political authorities and committed to price stability.

However, the fear in regard to the excessive German power in the new setting contains logical and empirical deficiencies. First, if power is the key factor in the motives and behaviour of states, then the German desire for EMU is itself puzzling. For why should the Germans favour a change in the monetary regime that will compromise on Germany's DM, which is the source of its pride, and the Bundesbank which would no longer frame autonomous monetary policies for others to follow. Rather it would be subsumed within the European System of Central Banks (ESCB). Further, the argument based on German power says nothing about the goals of the other EC states. If Germany's wishes had contradicted the objectives of its EC partners, it would have been easy for other states to stall, sabotage, or reject the EMU process at any time during negotiations. In fact, there existed a broad consensus among EC member states on many of its fundamental aspects, explains more than does German. Still further, countries that happen to be powerful do not always have their way in international negotiations. Observable power resources do not necessarily convert into bargaining leverage. Much depends on the value that various actors attach to the potential outcomes, including the "no agreement" outcome. At several points in the EMU negotiations, in fact, the bargained outcome did not match the German position. The empirical evidence shows that the Germans did not have there way on all issues.

As regards the second apprehension, the answer could be both "Yes" and "No". Yes, because in a very real sense national governments have seen fit to hand over some control of their own economies in order that other benefits may accrue. The benefits of full EMU to the consumer and to businesses and the benefits to national governments and their central banks or current equivalents are equally wide-ranging.

A move to common currency will allow Member states to have greater influence over each other's economic policies and therefore over each others interest rate variations. Smaller countries may have a far greater say over the economies of larger countries in consequence, as each country will have a single vote on decisions on monetary policy taken by the European Central Bank.

A single currency would also be able to withstand, far more confidently the pressures brought to bear on separate national currencies by speculators. Sudden devaluations would become a thing of the past. This would also discourage uncertainty about interest rates Furthermore, by resisting membership of the single currency, a national govt. would be effectively denying itself the right to have a say in how the European Central Bank functions, and thus, in some ways, in how the Community itself keeps moving forward.

EMU - The Obstacles

The Maastricht treaty met with little applause from European societies and international markets alike - what proved to be a agonizing process in ratification of the treaty coincided with the turmoil in the exchange markets, and the two became mutually reinforcing. The treaty survived in the end while the EMS suffered serious damage. A short time later, the return to higher rates of growth, coupled with the greater stability in exchange markets, helped to bring EMU project back on the agenda, thus confirming once again the strong sensitivity of the process of European integration in general to the economic state of affairs. The process soon gathered new momentum and thus the establishment of a complete EMU before the end of the decade became once again a credible proposition. The creation of the European Monetary Institute (EMI) in 1994, marked the second stage on the road to EMU, which made a real difference in terms of the analytical work and the technical preparations needed for the final stage.

A number of important decisions were taken at the European Council meeting held in Madrid in December 1995. It was first of all agreed that the final stage of EMU would start on 1 January 1999, thus officially dropping the option of 1997 mentioned in the treaty. The crucial and highly sensitive decision about which countries fulfil the convergence criteria will need to be taken early in 1998 on the basis of the relevant data for the previous year. The final stage will start with irrevocable fixing of conversion rates among participating currencies and against the Euro, which is the name finally adopted for the single currency. The withdrawal of national currencies will be very gradual after the entry into the final stage. According to the Madrid Council decision, the Euro and those national currencies participating in the final stage of EMU will coexist, with conversion rates established by law, until July 2002 when the Euro is planned to become the only legal tender. Banknotes and coins will begin to circulate at the latest by 1 January 2002. In the meanwhile, private economic agents will be able to use the Euro in their financial transactions, while public authorities will gradually shift from national currencies to the new European currency in the issuing of new public debt.

The Madrid council also identified two major outstanding questions which would require answers before the beginning of the third stage. The first question relates to the kind of arrangements needed to ensure budgetary discipline in the context of monetary union, thus implicitly accepting that the provisions made in the Maastricht treaty were not sufficient. The Germans were already pressing for the adoption of a 'stability pact' which would go further than the excessive deficit procedure mentioned in the treaty. The second question is about relations between ins and outs (or the 'pre-ins', as those more optimistic prefer to call themselves after entry into the final stage. Would the 'Outs' participate on a new kind of ERM. Would the ECB intervene in exchange markets to influence the exchange rate of those currencies and what kind of coordination of policies and budgetary discipline should apply to countries in "derogation" or with an "opt-out" are the questions which loom large on the horizon. Fearing competitive devaluations, France was keen on establishing a mechanism which would impose some discipline on the 'outs'.

Typically, Britain was fervently arguing in favour of a complete freedom in the conduct of economic policy and exchange rate policy.

The Union has been preparing for the crucial meeting scheduled for the early months of 1998 when the select few will be chosen for the final stage of EMU. But the fact is that the transitional period and the uncertainty associated with it, will not completely end with the selection of the first countries to participate in the final stage. And then, there will be more than three years until the Euro takes over completely as the single currency. This is more than enough time for the markets to undo the plans designed by politicians.

The journey to EMU will therefore be dangerously long and prone to many accidents. The credibility of the project will depend on the continuous interaction between governments, societies and markets. With very few exceptions, EU governments seem to be committed to the objective of a complete EMU and to the pursuit of policies aimed at fulfilling the convergence criteria, thus ensuring their early participation in the final stage. This does, however imply the pursuit of restrictive policies, especially in order to meet the convergence criteria relating to public deficits and debt. But the million dollar or rather the "million Euro" question is that will the electorate go along with these in times of high unemployment all over the Euro Area.

The remaining part of the journey to EMU, it seems well be highly sensitive to changes in the political and economic weather. A prolonged period of economic recovery would greatly facilitate the journey, but such a recovery will not be helped by the kind of budgetary policies which need to be pursued in conformity with the convergence criteria. The political climate, especially in the two most important countries, namely France and Germany, is another unknown variable.

The convergence criteria on the basis of which admission to the final stage will be decided by qualified majority in the European Council following reports by the Commission and the European Monetary Institute (EMI) can be criticized on many grounds. They are mechanistic, some of them are arbitrary and perhaps also superfluous. Worst of all, they may actually do serious damage by contributing to a deterioration in the macroeconomic environment and thus undermining the political and social acceptability of the EMU project.

In addition to this, the convergence criteria adopted do not refer to any real economic variables. The convergence criteria are based on the assumption that there is no real trade off between price-stability on the one hand and growth and unemployment on the other.

Arguably, adjustment for countries with higher inflation rates and/or higher public deficits and debts would be easier in a monetary union than during a rather long transitional period leading to it, as long as the appropriate rules were adopted to ensure the credibility of the new monetary regime. Several proposals have been made in this direction to try to shift the focus away from the convergence criteria as a precondition for entry into the EMU and towards the adoption of tighter constraints in the conduct of national budgetary policies in the context of a monetary union. Thus, the transitional period could be made shorter, the risk of destabilizing speculation during this period would be reduced, and the admission of countries to the final stage would be made easier.

The transition to a complete EMU will make no sense without Germany and France. Thus the beginning of the final stage depends on whether those two countries are able to meet the criteria set out at Maastricht, with the possibility that some of those criteria may need to be interpreted in a rather loose manner.

Thus, the application of the convergence criteria may involve some difficult political decisions and the haggling which usually accompanies such decision. The strong possibility that at least several EU members will be excluded from the first selection, coupled with the economic political and institutional importance of EMU, means that a major, new step will have been taken in the direction of a multi-tier and multi-speed Community. The rights and obligations of those who stay out willingly or otherwise, still remain to be defined.

With the decision to proceed to a complete EMU, European political leaders have decided to play with very high stakes. EMU could divide the EU; it could destabilize politically if the new institutions do not enjoy the legitimacy which is necessary to carry their policies through, and it could create economically depressed member states and regions. These are the main risks. On the other hand, if it works, it will accelerate the process of economic integration, thus giving a much more concrete and stable form to the internal market; and it is also bound to create a new momentum for political integration as a necessary corollary to monetary union.

EMU - How can it work?

Critics suggest that while a single currency might be a good idea for Europe in theory it cannot work in practice. Various dire consequences of any move to EMU are often mooted, from higher unemployment through permanent recession and even war. All of these have to be taken with a pinch of salt as the idea that France and Germany will fall out over EMU only stands up if one believes that French and German goals are incompatible. But the experience of the past ten years or so suggests quite the opposite. Ever since the French began to pursue the France forte policy they have clearly been pursuing the same end as Germany - an economy founded on sound money. Indeed there is no reason to believe that the French want to take over the Bundesbank simply to weaken it. If that were the case why would France have made its central bank independent and have been running a monetary policy, which could claim to be more German than Germany's own? (Sir Leon Brittan (LEEDS), 18 October 1996).

Equally there is no reason to believe that EMU necessarily contains the seeds of its own destruction. The argument goes that as the price for joining EMU, Germany will insist on interest rates which are too high for the rest of Europe, which will lead to increased unemployment across Europe because governments will no longer be able to devalue their currencies and create export led recovery. There is no evidence to suggest that Germany would insist, for its is understood that high interest rates in 1992 ripped the rest of Europe. When the President of the Bundesbank admitted German interest rates were too high for the rest of Europe during the early 1990s, he added that Germany's Central Bank had to have a policy for Germany while the European Central Bank which is proposed for the EMU, would have policy for Europe.

There is no reason why the sort of policies which have to be formulated under EMU should produce a greater tendency to unemployment. Rather, the opposite may be more apt and true. The European Central Bank will be legally required to ensure low inflation, while governments will also be bound by law not to run up excessive debts; sound principles of British Conservative economics which the rest of Europe is also following. These policies will actually help to keep unemployment down, by creating a climate of stability which fosters growth and job creation. They are a proven quality as they have worked for Germany after all, for even including East Germany, its unemployment rate is lower than Britain's. It is an outdated and discredited view that the route to high employment is through repeated doses of devaluation.

It is true that some parts of the Union might at some point in the future face structural problems different from other parts. This is something which sceptics about EMU alight upon with glee. In their view it is too risky to surrender a tool of adjustment like the exchange rate because Europe has no compensating mechanism in the form of labour mobility, which could absorb the shock. There are two responses to this. The first, devaluation, is a discredited tool. It is neither effective nor efficient. It is not efficient in part because it can often lead to inflation by making imports more expensive. And it is not effective because it cannot target the regions worst hit by structural problems. It is a blanket measure which will first benefit those areas already prospering before it helps those in need of assistance. But much more important is the fact that reliance on the exchange rate instrument allows governments to avoid making necessary changes to the economy in order to maintain its competitiveness, be it encouraging investment, and training or reducing labour costs or dealing with other fundamental structural weaknesses.

In the second place, while there may well be less labour mobility in Europe than in other developed countries, this is not necessarily an insuperable obstacle provided that wage flexibility exists. Around Europe today, governments are already putting in place measures which will create greater labour market flexibility of the sort which will be needed in EMU and which are indeed needed in any event. Belgium's Global Plan for example, includes steps to reduce the costs of labour and adapt the social security system to reduce non wage employment costs. France has adopted measures to ease the costs of employing less skilled labour. This is the work that needs to continue and hopefully it will continue. So the Europeans should not allow themselves to get sidetracked into arguments that being part of a single currency could raise unemployment, or make it significantly harder to tackle. The opposite could well be true and EMU could even help to get more of Europe back to work.

The two IGC's and the EMU

Inter-Governmental Conference (IGC) is a forum set for negotiations among the EU's 15 member states on reforming EU's institutions and revising the 1992

Maastricht treaty. The two IGC's held at Turin and Amsterdam respectively aim to make EU institutions and work procedures more efficient so that, early in the next century, EU can incorporate new members ranging from Cyprus to Malta to the emerging democracies of Central and Eastern Europe.

European Monetary Union was the ghost at the two IGC's as officially, it was not up for discussion, since the decision to create a single currency was taken at Maastricht. Countries that fulfil the criteria for EMU are to be named in early 1998, their national currencies are to be locked together in January 1999, and the Euro is to go into circulation in 2002.

Unofficially, the EMU did influence the IGC talks. With almost all EU states finding it hard to meet the strict EMU criteria doubts hung over whether the project can or should start. If it does not, the prospect for EU enlargement into central and eastern Europe may recede, since some governments argued that enlargement without EMU would spell the end of the EU's dream of "ever closer union".

At the IGC at Turin on 29 March 1997, which was chaired by Mr Lamberto Dini, President of the European Council and Prime Minister of Italy. The union firmly committed to the full implementation of the treaties, including its provisions on economic and monetary union. Germany called for a lean agenda and expressed disappointment at Britain's refusal to accept greater integration in Europe. With a resolve to make the Union more efficient, internally as well as externally the European Union moved on the three year countdown to the launch of a currency that will challenge the global supremacy of the dollar in the 21st century. They further decided to settle all outstanding issues involved in the transition to a Single currency, paving the way for the European Commission, the EU's executive wing and EU member governments to "sell" the euro to the man in the street who, if all goes well, will be spending the coins and notes of the new currency staring July 2002.

The stakes are high that inspite of the completion of the ground work done at the EMI at Frankfurt. The choice of date for the irrevocable fixation of the exchange rates sparked fresh controversies. France fought for economic data to be evaluated in late 1997, mainly to avoid the EMU selection process clashing with its parliamentary elections in the spring of 1998. But Germany successfully argued that such a momentous decision required the most reliable figures, which will only be available in early 1998.

It was under these circumstances that Dutch presidency of the European Union became important and crucial considering the fact that another Intergovernmental Conference (IGC) reviewing the Maastricht treaty was successfully concluded the IGC at Amsterdam on 16 and 17 June 1997 with full agreement on a draft treaty based on the texts (doc. CONF 4001/97).

The European Council welcomed the contributions by the council, the Commission the European Parliament and the EMI, which have made possible further concrete steps in view of the start of EMU on 1 January 1999 and to safeguard its successful functioning:

- The European Council adopted a Resolution laying down the firm commitments of the Member States, the commission and the council regarding the implementation of the Stability and Growth pact.
- The principles and fundamental elements of a new Exchange Rate mechanism (ERM 2) to be established as from 1 January 1999 have been laid down in a Resolution which the European council has adopted.
- There is now complete agreement on the two Regulations which constitute the legal framework for the euro. The first Regulation is based on Article 235 and has already been adopted, while the second Regulation will be adopted by the Council immediately after the decision on Member States participating in the euro area has been taken as early as possible in 1998.
- The European Council welcomes and fully endorses the choice for the design of the euro coins. Together with the euro bank notes, this provides a tangible sign to citizens of the preparations for the euro.

According to the European Council the progress achieved signified that most of the technical preparations for the EMU have been accomplished and the remaining period should be used to step up the practical efforts of all actors, including public administration, in preparing for the introduction of the Euro.

Further, the European Council invited the council and the Commission to examine and indicate how to improve the processes of economic coordination in stage 3 of the EMU consistent with the principles and practices of the Treaty and noted that the strenuous efforts of the Member States towards achieving a high degree of

Sustainable convergence, notably in the budgetary area, are contributing to improved prospects for growth and employment in 1997 and beyond.

Finally the European Council welcomed the understanding reached by the council on the time frame for the implementation, as early as possible in 1998, of the procedure laid down in Art 109(4). This time frame should allow the European parliament to play its full role in the process. With the start of the third stage of economic and monetary union, the European Monetary system will be replaced by the exchange rate mechanism as defined in the Amsterdam Resolution. The operating procedures will be laid down in an agreement between the European Central Bank and the national central banks of the Member States outside the euro area.

The exchange rate mechanism will link currencies of Member States outside the euro area to the euro. The euro will be the centre of the new mechanism. The mechanism will function within the requisite framework of stability-oriented policies in accordance with the EC Treaty which are at the core of the EMU.

The agreement reached at the European Union inter government conference in Amsterdam aims at keeping European Monetary Union (EMU) on course for its January 1999 launch. At the same time, the recent election results in France, skirmishes between the Helmut Kohl's government and the Bundesbank in Germany and the general disillusionment of EU citizens with austerity politics linked to meeting the Maastricht Convergence criteria continue to cast doubt over the EMU timetable and criteria. The centre-right coalition under Helmut Kohl is paralysed by its worst budget crises in decades (International Herald Tribune (Hong Kong) 16 June 1997).

Also Germans are suspicious of Italy's financial management while Italians are enraged at being treated like second-class Europeans. On the other hand Britain is mainly intent on preserving British veto over common border controls and defence policy rather than for the EMU. Coupled with this goes the Franco-German confrontation over the Community's economic future and the harsh noises involve French determination to create some kind of politically controlled body or agency to averse the monetary policy making prerogatives of the future European Central Bank. The new socialist government in Paris insists on reaching compromise solutions, accepted at the IGC to accompany the stability pact for European Monetary Union, as a signal to bring the independence of the future Eurobank under control.

Considering that Germany conceived the European Central Bank and the stability pact to guarantee that a unified European economy and currency would mirror its own institutions for the foreseeable future, the French position pointed at the heart of the German concept for the monetary union and meant that the truce being evidenced between them may be short lived.

Yet, none of these concerns are new and the basic issues of merging EU national currencies are the same as they were when the plan was devised in 1992. At a time when Europe is still experiencing the after-effects of recession and with 18 million people unemployed across the EU, Government are increasingly getting concerned about job creation and security than anything else. Against this background, the old conundrum of now-versus tomorrow is a central question. The challenges of implementing euro are here today; the advantages all lie in the future.

Moreover, much of the belt tightening attributed to the Maastricht in reality forms part of wider strategies that most European Governments are following. These programmes aim at reducing public spending in order to make national economies more competitive in world markets and to cope with spiralling social security deficits. As regards the Franco-German feud, the Italian foreign minister, Lamberto Dini said that he was confident that differences between the two countries would be resolved with a rational form for Euro bank being devised and there would be a room for a flexible interpretation of the Maastricht targets on government deficits.

Finally, the supporters at the Amsterdam meet said that the euro will create a powerful new currency zone to compete with the US and Japanese economies and that it will consolidate Europe's internal market. Rising business volumes and more jobs will follow as a result of which European states will find it harder to give in to protectionist reflexes.

Thus, a scrutiny of the developments say that EC can neither reverse current trends nor bring them to a halt. Any such attempt will necessarily result in a segmented community with some countries further progressing towards integration while others become satellite economies. The economic implications for both sets of countries of such a development would be unacceptable. Therefore, one may conclude that by the end of the decade, European Monetary Union will be established.

As some final words of conclusion it may be said that the vision of the Maastricht treaty on EMU was terse and unambiguous. "A single Europe by the turn of the century". It almost had the flavour of those famous words of John F. Kennedy in the early sixties - "we will put a man on the moon by the end of this decade". And like every great vision, the vision of a single Europe and a single currency also has timetable.

The countdown has surely begun. Perhaps, no other economic event has generated so much passion and debate on a global scale across such a wide cross section of people. From the blue blooded Anglo-Saxon investment bankers to the fleet-footed forex dealers in global currency markets, from high profile investment analysts in wall street to their more humble brethren in Dalal street, from senior economists at the G7 central banks to the economists in developing countries, from the occidental power magnates to oriental maverick traders and from formal conferences and seminars to informal cocktail circuits, almost everybody is training to analyze its impact and implication in his own little way. Economic thinkers have hailed it as the most, momentous event in global economics, after the rise of Japan, in the post war scenario.

As 1 January 1999, the date for the single currency in Europe draws closer and the European nations are running short of loopholes to delay the processes any further, the emergence of a third economic force appears increasingly imminent.

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