



RESEARCH PAPER 98/35  
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# **EMU: the approach to the Third Stage and the state of economic convergence**

This Paper summarises some of the technical and political developments concerning the preparations for EMU, as well as recent documents published by the Commission. It also examines progress made by Member States as measured against the convergence criteria according to the latest economic data.

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## I Summary

This paper looks at preparations for the start of economic & monetary union (EMU) that have taken place over the last 15 months. The way in which the Member States' economies will be directed is now clearer. Two options, money supply targeting and direct inflation rate targeting, are the preferred means by which the future European Central Bank [ECB] will judge the state of the euro-zone economy and hence the need to alter monetary conditions within it.

The Paper also examines the high profile row over the future President of the ECB. Efforts to produce a compromise candidate have failed so far and it now looks to be a straight contest between the French and Dutch candidates.

The most public manifestation of the development towards EMU is the final determination of the designs of the euro notes and coins. Pictures of the notes can be seen in the appendix to this Paper.

This Paper also lists the five tests by which the government will assess whether conditions are appropriate for the UK's entry into EMU. Briefly these are:

- i. Whether there can be sustainable convergence between Britain and the economies of a single currency.
- ii. Whether there is sufficient flexibility to cope with economic change.
- iii. The effect on investment.
- iv. The impact on the UK's financial services industry.
- v. Whether it is good for employment.

Lastly, the Paper explains the methodology behind the convergence criteria and looks at the latest economic data for all Member States to determine the likely number of qualifiers. It finds that the assumption of a large number of qualifiers depends heavily on a flexible interpretation of the criteria.

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In this Paper all Article references are to articles in the Maastricht Treaty as they will be numbered according to the new numbering of the Treaty on European Union that would come into force if the Treaty of Amsterdam is introduced into national law.<sup>1</sup>

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<sup>1</sup> Treaty of Amsterdam, October 1997, Cm 3780

## II Technical developments

### A. Monetary policy

In 1997 the European Monetary Institute (EMI) published two important documents outlining how EMU will operate. These documents were:

*The Single Monetary Policy in Stage Three; specification of the operational framework*, January 1997 and;

*The Single Monetary Policy in Stage Three: General documentation on ESCB monetary policy instruments and procedures*, September 1997.

Although the EMI will cease to exist from the commencement of Stage Three on 1 January 1999 it has a duty under the Maastricht Treaty to prepare the institutions and the operational framework for monetary policy within the euro zone. Essentially its role is to prepare the ground for the European Central Bank when it takes over. The first of the two documents indicates how monetary policy will work after 1999.

The EMI note that:

As regard the final objective itself, the Treaty provides unambiguous guidance that “ the primary objective of the ESCB shall be to maintain price stability” (Art 105 (1)). However, in its pursuit of this objective, the ESCB, like all central banks, will face a complex transmission process from policy actions to price developments, which will, be characterised by several interlinked transmission channels with long and variable lags.<sup>2</sup>

The EMI evaluated five possible monetary policy strategies against criteria that included the following elements, effectiveness, accountability, transparency, medium-term orientation, continuity and consistency with the independence of the ESCB. Three options were rejected as not complying with the criteria, exchange rate targeting, interest rate pegging and nominal income targeting. Two options remain, money supply targeting and direct inflation rate targeting. The EMI has yet to decide which of these are more suitable. It may be the case that some combination of the two approaches is used; this is hinted at in the following extract outlining the key elements of Stage Three:

The public announcement of a specific target (or targets) against which the performance of the ESCB can be assessed on an ongoing basis by the general public;

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<sup>2</sup> *The Single Monetary Policy in Stage Three; specification of the operational framework*, p11

The use of all available information relevant to the final target of monetary policy...In line with current practice, it would seem appropriate for this set of variables to include financial variables (in particular the money market yield curve, money and credit aggregates, credit market conditions, bond yields, exchange rates and other asset prices) and various non-financial variables (such as price and cost variables, indicators of aggregate demand and supply conditions including the output gap, the balance of payments and expectations surveys;

Within the set of indicators employed by the ESCB, monetary aggregates should be assigned a prominent role, with either targets or monitoring ranges set for their growth, provided that money demand is sufficiently stable in the long run;<sup>3</sup>

### **B. Exchange rate policy co-operation**

As well as internal monetary policy, the EMI has prepared a framework for managing the external value of the euro. This has been most involved and sensitive with respect to the relationship between the euro and the currencies of EU Member States outside the euro zone.

In a Report to the European Council Session in Dublin in December 1996, uncontrolled exchange rate movements between the 'ins' and the 'outs' were seen as being contrary to the spirit of the Single Market and hence there is an obligation under the Treaty to treat exchange rate policy as a matter of common concern.

The proposal is that there will be a new ERM, albeit one that looks similar to the old ERM:

The new exchange rate mechanism would be based on central rates, defined vis-a-vis the euro for the non-euro area currencies. A standard fluctuation band would be established for these currencies around their central rates. Although the exact size of the standard fluctuation band has yet to be decided, it is expected to be relatively wide.<sup>4</sup>

The central rates and the width of the band will be set by agreement with the Member States in the euro area and those currently in the ERM.

Most EU Member States' currencies are bound together within the exchange rate mechanism [ERM]. Within this structure each currency has a fixed central rate against the ECU (and of course against all other members) and currencies (with two exceptions: Germany and the Netherlands) may vary in value up to plus or minus 15% of this central rate. There have been some significant developments with respect to the existing ERM structure.

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<sup>3</sup> op cit p 14

<sup>4</sup> op cit p 67

First its membership has increased by one. Greece entered the ERM for the first time on 14 March 1998 at a central rate of Dr 375 to the ECU. This is a significant move by Greece as it is a major step on the road for the country to meet its stated objective of EMU membership by 1 January 2001.

Secondly, the transition from ERM to EMU has become somewhat clearer. Also on 14 March 1998 the Irish Punt was revalued by 3 per cent against its central rate. Ireland's currency had been trading significantly above its central rate for many months. While this persisted the adoption of ERM central rates as the starting point for EMU seemed unlikely. If Ireland was not going to join at its central rate then clearly there was room for other countries to argue for non-central rate joining parities too. The revaluation has removed this problem and it is now almost certain that the values at which currencies join the EMU will be their current central rates.

### **C. Economic Management**

One subject which has been the focus of much attention in the last year has been the preparation of statistics designed to enable the ECB to do its job. Currently, the preparation of comparable Europe-wide statistics takes too long a period of time to be of use to the ECB for its task of setting interest rates. Hence a range of statistics covering demand, output and labour costs on a consistent basis have been agreed upon. A harmonised index of consumer prices (HICPs) has been drawn up already for all EU countries to be used in the convergence assessment exercise. The ECB will use the HICP in the form of an index covering the euro area as a whole as the main index of inflation.

For a picture of demand pressures in the economy the ECB will rely upon data on manufacturing, construction and retail sales. It will also use business opinion surveys and trade data.

### **D. ECB Chairmanship**

Since the EMI is the forerunner organisation to the ECB it was commonly supposed that its current chairman, the Dutch central bank President Wim Duisenburg, would naturally become the ECB's first Chairman. This assumption has been challenged by the nomination, by the French, of a new candidate, the President of the Bank of France, Jean Claude Trichet. Apart from national sensibilities there is no obvious reason why the French candidate was proposed, nor why at such a late stage. The candidates have equally sound credentials for the post and

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there is no suggestion that they hold very different perspectives on the role of a central banker. There has been some suggestion in the press that the French believed that there existed a 'deal' under which the ECB went to Germany (Frankfurt) but with a French leader, however, there has never been any confirmation of the existence of such an agreement. Efforts made in the autumn to produce a compromise candidate failed and it now looks to be a straight contest between the two candidates.

Speculation in the Press about alternative candidates began almost as soon as the French candidacy was announced. A typical article commented:

.....in the margins of a meeting of European Union finance ministers in Brussels it appeared France's decision to put forward its own candidate - Jean-Claude Trichet, head of the Bank of France - would encourage others to enter the race for one of the most prestigious jobs in international finance. Spanish officials said Luis Angel Rojo, governor of the Bank of Spain, was a likely candidate for the ECB post. Philippe Maystadt, the highly regarded Belgian finance minister and Chairman of the International Monetary Fund interim committee, was also being mentioned. 'The nomination of Mr Trichet means that there will be an open contest,' predicted one EU diplomat. 'That means there will be four or five candidates.'

'If it comes to a stalemate (with the French), then it will be neither (Trichet nor Duisenberg),' said one Dutch diplomat. 'There will be a third choice.'<sup>5</sup>

### E. Euro notes and coins

The most public manifestation of the development towards EMU is the fact that the final designs for all the notes and coins have been approved and decided upon, except for certain security details. Pictures of the notes can be seen in the appendix to this Paper. According to the Bank of England the UK has preserved the option to include a national feature on euro banknotes issued in the UK if it were to participate in EMU.<sup>6</sup>

With respect to the coins, which have values of 1, 2, 5, 10, 20 & 50 cents and 1 & 2 euros, one side will feature either a globe or a map of Europe, depending on the denomination, against a background of transverse lines and the other side will feature a national design. It has recently been confirmed that the issue date for notes and coins (E Day) will be 1 January 2002. Many retailers have commented that the coincidence of January sales and the introduction of a new currency could hardly be worse from a practical point of view.

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<sup>5</sup> *Financial Times*, 6 November 1997

<sup>6</sup> *Practical Issues Arising from the Introduction of the euro*, Bank of England, August 1997

## F. Convergence

The Maastricht Treaty outlines the future path towards full economic union, and tries to avoid the experience of German reunification, which showed just how painful immediate union can be despite the massive, initial, political will in support of it. A crucial element in this is the economic policy and behaviour of Member States - 'convergence' – measured against five key tests in what are collectively known as the convergence criteria (described more fully in a later section of this Paper). Member States regularly submit their own convergence plans to the Commission for comment. The convergence programmes are discussed by the Monetary Committee (see above) and in ECOFIN Council meetings (including the UK delegation). In this context one recent event to attract economic interest was the consideration by Ecofin of the convergence plan put forward by the Italian government.

Italy is one of the largest economies in Europe and is one of the most enthusiastic political supporters of EMU. However, its economic performance has not always matched up to its political aspirations. At issue, in the ECOFIN meeting was whether the EMI and the political leaders in Europe considered the Italian budget reduction plan credible and could be relied upon to form the basis for Italy's candidature for entry in the first wave of countries. The importance of the Italian meeting is that it is a good guide to official thinking ahead of the definitive meeting in May and gives one a good idea of what sort of institution EMU is likely to be. An article describing the meeting is reproduced in part below:

With the eyes of the world's financial community fixed on the unfolding crisis in Asia, preparations for the advent of the single currency next January have been thrust into the shadows. Yesterday, monetary union emerged into the spotlight and it was business as usual. At the heart of yesterday's Ecofin debate was the question of what to do about Italy, one of the original six members of the Common Market and a country intent on being in the first wave next year. Italy, like many other EU states, has been through a great deal of self-inflicted pain in recent years, taking the axe to public spending and raising taxes to bring public finances under control. The problem is that according to the convergence criteria for membership laid down in the Maastricht treaty, Italy has not done nearly enough. It has low inflation and is running a big primary budget surplus, (excluding debt interest payments) but one of the criteria is that countries should have a stock of national debt equivalent to no more than 60 per cent of its annual output as measured by gross domestic product. Because of its past economic sins, Italy's is more than 120 per cent.

But Italy is not alone in failing to meeting the Maastricht terms. Belgium's debt position is equally poor, while years of sluggish growth have meant that even Germany does not qualify under a strict interpretation. Few countries actually would. The scene, according to the French bank, Paribas, is set for a debate over the coming weeks between two different schools of thought. On the one hand there is the 'structuralist' camp - headed by France and Italy - which sees monetary union as a way of achieving greater economic integration. On the other there is the 'economist' camp - led by Germany and the Netherlands - which insists that convergence must come before monetary union. In Germany, Chancellor Kohl, the prime mover behind the single currency, faces a challenge in the Constitutional Court at a time when public opposition to the Euro is hardening and an election is looming. In theory, the argument should be settled in favour of the 'structuralists'. The single currency is a political construction with an economic superstructure bolted on for good measure.

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The fact that the Maastricht treaty allows for flexibility means that it will be interpreted generously, resulting in 11 of the 15 EU members signed up for monetary union from the outset.<sup>7</sup>

Since this date, all Member States have had to submit the results of their economic performance in 1997 to the Commission, by 28 February 1998, and the results are described in the following section. The Commission and EMI have until 25 March to prepare their own conclusions as to the suitability of Member States for membership.

### G. Business Preparations

Regardless of the eventual UK decision about participation in EMU, businesses in the UK have to assess what preparations they will have to make in order to cope with EMU when it happens. Clearly the need to make changes and the degree of preparedness of business varies hugely. Small firms in the service sector may reasonably conclude that they can safely take no action at this stage. On the other hand large multinational companies with subsidiaries in likely EMU Member States are having to consider a variety of practical issues, inter-company invoicing, treasury operations etc, as well as more strategic issues such as pricing structures and siting of production facilities.

In October the Chancellor alluded to some of the changes currently under way in his speech (see following section) on EMU entry. He also outlined the Government's contribution:

The questions of preparation are immense – practical questions for business, as well as for government. Some companies, like Marks and Spencer, have already decided to prepare to accept euros in Britain. Others, will want advice on what is best for them.

Because both the Government and business must prepare intensively during the next years, we will:

commence work on the detailed transition arrangements for the possible introduction of the Euro in Britain, including the introduction of notes and coins, should we wish to enter;

step-up the work on what business should do now to prepare for the introduction of the Euro in 1999, whether we are in or out;

work with business on what government must do to prepare for EMU, should we decide to join it in the next parliament.

To help with essential preparations, I have invited the Governor of the Bank of England and Sir Colin Marshall, the President of the CBI, to join me and the President of the Board

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<sup>7</sup> *Guardian*, 20 January 1998

of Trade in leading a standing committee on Preparations for EMU. I am pleased to say that they have agreed. I am also inviting the President of the Association of British Chambers of Commerce to join us. I can also announce that, from January a series of regional and sectoral conferences on preparations for monetary union will be held.<sup>8</sup>

In its publication *Practical Issues Arising from the Introduction of the Euro* the Bank has included as a regular feature contributions from a variety of, mainly, financial companies about the way in which they are preparing for the euro and, in some cases, how much it will all cost. Selections of these reports from the last two editions are summarised below. It is hoped that this will give a feeling to the work that is currently underway.

### **Barclays Bank (August 1997)**

Working assumption of EMU on time but with the UK out.

“Barclays’ position that a minimum notice period of 36 months should be given preceding UK membership of EMU.”

“Many customers have undertaken little or no planning for the euro.”

“Euro capability will not come cheap either in terms of IT spend or of customer and staff education: and existing revenue streams, from foreign exchange and payment traffic for example will also be significantly reduced.”

### **Midland Bank: HSBC (August 1997)**

“Whether or not the UK participates initially, wholesale markets and customers will be affected from the outset, and the HSBC Group’s priority is to be able to meet this demand. For instance, Midland Bank is preparing to offer at least the following euro products from January 1999: current accounts; loans and deposits; payments and cash management services; documentary credits and other trade products; foreign exchange, futures, swaps and options; and corporate and bond trading.”

“[an] estimation of IT resource implications: it suggests that EMU work will at its peak occupy some 20% of Midland’s computer programmers if the UK is in, but only 5-10% if the UK is out.”

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<sup>8</sup> HC Deb 27 October 1997, c583 - 588

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### **ABN AMRO Bank (December 1997)**

“As regards the City of London...it has been assumed that the ‘London financial infrastructure’ including the Bank of England, LIFFE, Crest, APACS, CHAPS amongst others would be ready to serve the financial community in euro with effect from 1 January 1999, despite the UK being ‘out’.”

“EMU is causing corporates, both domestic and multinational, to reassess the fundamental logic of their areas of operation, internal structure and sources of capital raising. The creation of the single currency market, even in the ‘first wave’, is anticipated to increase US investor interest, acceleration of the move from debt to equity, and a cheaper cost of funds due to the enhanced depth and liquidity of the financial markets in Europe.”

### **NatWest Group (December 1997)**

“Now that the government has announced that it would in principle like the UK to enter EMU early in the next Parliament, we are reconsidering our plans for UK entry, but timing of entry will need to be more certain before we commit the necessary investment for full scale euro preparation in retail banking.”

### III The UK: Political & Economic Developments

#### A. UK Government's Conditions for Entry

Because of its 'opt-out' in the Maastricht Treaty, the UK is in a position shared by only one other Member State (Denmark): it has some say in judging whether or not it wants to enter EMU. The Chancellor, in a statement to the House in October, announced the criteria against which the government will judge the suitability of the UK's membership of EMU.<sup>9</sup>

The Chancellor said:

The decision on a single currency is probably the most important this country is likely to face in our generation...Now is the time to make these hard choices and set a long-term direction for our economic future in Europe. So I will deal, in turn, with the question of principle, the constitutional implications of EMU, and the economic tests that have to be met. In each area, I will set down the Government's policy.

I start with the question of principle. The potential benefits for Britain of a successful single currency are obvious: in terms of trade, transparency of costs and currency stability. Of course, I stress it must be soundly based. It must succeed. But if it works economically, it is, in our view, worth doing. So in principle, a successful single currency within a single European market would be of benefit to Europe and to Britain.

Secondly, it must be clearly recognised that to share a common monetary policy with other states does represent a major pooling of economic sovereignty. There are those who argue that this should be a constitutional bar to British participation in a single currency, regardless of the economic benefits it could bring to the people of this country. In other words, they would rule out a single currency in principle, even if it were in the best economic interests of the country.

That is an understandable objection and one argued from principle. But in our view it is wrong. If a single currency would be good for British jobs, business and future prosperity, it is right, in principle, to join.

There is a third issue of principle - the consent of the British people. Because of the magnitude of the decision, we believe - again, as a matter of principle - that whenever the decision to enter is taken by government, it should be put to a referendum of the British people. So whenever this issue arises, under this Government there will be a referendum. Government, Parliament and the people must all agree.

So we conclude that the determining factor as to whether Britain joins a single currency is the national economic interest and whether the economic case for doing so is clear and unambiguous.

I now turn to the Treasury's detailed assessment of the five economic tests that define whether a clear and unambiguous case can be made.

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<sup>9</sup> HC Deb 27 October 1997, cc583 - 588

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These are:

- i. Whether there can be sustainable convergence between Britain and the economies of a single currency.
- ii. Whether there is sufficient flexibility to cope with economic change.
- iii. The effect on investment.
- iv. The impact on our financial services industry.
- v. Whether it is good for employment.

### i. Economic Cycles

Of these, the first and most critical is convergence: can we be confident that the UK business cycle has converged with that of other European countries so that the British economy can have stability and prosperity with a common European monetary policy? That convergence must be capable of being sustained and likely to be sustained - in other words, we must demonstrate a settled period of convergence.

Currently Britain's business cycle is out of line with our European partners....This divergence of economic cycles is, in part, a reflection of historic structural differences between the UK and other European economies, in particular the pattern of our trade and North Sea oil. These differences are becoming less distinct as trade with the rest of Europe grows and the single market deepens.

We will need a period of stability with continuing toughness on inflation and public borrowing. The Treasury's assessment is that, at present, the UK's economic cycle is not convergent with our European partners and that this divergence could continue for some time. To demonstrate sustainable convergence will take a period of years.

### ii. Flexibility

To be successful in a monetary union, countries will need even more flexibility to adjust to change and to unexpected economic events once the ability of countries to vary their interest rates and exchange rates has gone and the Euro and a single European interest rate are in place. Flexibility may be particularly important for the UK if there is any risk that our business cycle has not fully converged with those of the other EMU members.

The Treasury assessment of the second test is that, in Britain, persistent long-term unemployment and lack of skills - and in some areas lack of competition - point to the need for more flexibility to adapt to change and to meet the new challenges of adjustment.

### iii. Investment

The third test is investment: whether joining EMU would create better conditions for businesses to make long-term decisions to invest in Britain. The Treasury assessment is that, above all, business needs long-term economic stability and a well-functioning European single market.

iv. Financial services

The fourth test asks what impact membership of the single currency would have on our financial services industry. EMU will affect that industry more profoundly and more immediately than any other sectors of the economy.

The Treasury's assessment is that we can now be confident that the industry has the potential to thrive whether the UK is in or out of EMU, so long as it is properly prepared. But the benefits of new opportunities from a single currency could, however, be easier to tap from within the Euro zone. This could help the City of London strengthen its position as the leading financial centre in Europe.

v. Employment

For millions of people, the most practical question is whether membership of a successful single currency would be good for prosperity and jobs. The Treasury assessment is that our employment-creating measures, and welfare state reform, must accompany any move to a single currency.

The Treasury assessment is that in vital areas the economy is not yet ready for entry and that much remains to be done. The previous policy of keeping options open, without actively making preparations, has left parts of the economy un-prepared.

Applying these five economic tests leads the Government to the following clear conclusions.

British membership of a single currency in 1999 could not meet the tests and therefore is not in the country's economic interests. There is no proper convergence between the British and the other European economies now. To try to join now would be to accept a monetary policy which would suit other European economies but not our own. We will therefore be notifying our European partners, in accordance with the Maastricht Treaty, that we will not seek membership of the single currency on 1 January 1999.

The issue then arises as to the period after 1st January 1999. We could simply leave the options open, as before, but with no clear direction either way for the rest of the Parliament. That would be politically easy but wrong.....It must be in the country's interest to have a stable framework within which to plan.

There is no need, legally, formally or politically, to renounce our option to join for the period between 1<sup>st</sup> January 1999 and the end of the Parliament, nor would it be sensible to do so. There is no requirement under the Treaty for this. What is more, no government can ever predict every set of economic circumstances that might arise.

What we can and should do is to state a clear view about the practicability of joining monetary union during this period. Applying our economic tests, two things are clear. There is no realistic prospect of our having demonstrated, before the end of this parliament, that we have achieved convergence which is sustainable and settled rather than transitory. And Government has only just begun to put in place the necessary preparations which would allow us to do so. Other countries have for some years been making detailed preparations for a single currency. For all the reasons given, we have not.

Therefore, barring some fundamental and unforeseen change in economic circumstances, making a decision, during this Parliament, to join is not realistic. It is also therefore

sensible for business and the country to plan on the basis that, in this Parliament, we do not propose to enter a single currency.

### **B. Other Parties' Positions**

#### **1. Conservative Party**

Following the General Election the new leader, William Hague, outlined a different approach towards UK entry to replace the previous 'when the time is right' formula. This is described in the following newspaper article:

William Hague, Conservative leader, last night committed his party to oppose UK membership of a single currency for 10 years. The decision to adopt the party's hardest position yet on European economic and monetary union (Emu) was seen as an exploitation of the government's difficulties over the issue. The shadow cabinet agreed the move after a 90-minute discussion, in spite of previous threats from at least three pro-Europeans to resign.

A Tory statement said the shadow cabinet agreed 'to support William Hague's intention to oppose Britain's membership of a single currency at the next election, subject to the agreement of party members nearer the time'.<sup>10</sup>

In a speech to the CBI Mr Hague spelt out his Party's approach to EMU membership.

I believe that a single currency carries with it fundamental economic and political risks. For this reason the Conservative Party believes it is a mistake to commit this country in principle to joining a single currency. We oppose Britain joining a single currency during the lifetime of this Parliament, and we intend to campaign against British membership of the single currency at the next election – subject, like all our major policies, to the approval of rank-and-file Conservative members nearer the time.

It is a clear and unambiguous position. It is also a pragmatic position based on what we believe to be in the vital interests of British companies and the British people.

A single currency is too important an issue to be decided by political fashions. Nor should we join just because other countries are going to. We should look at the merits of a single currency in the same sober, level headed way in which you would take a decision that could jeopardise the future of the company.<sup>11</sup>

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<sup>10</sup> *Financial Times*, 24 October 1997

<sup>11</sup> *Speech to CBI Conference*, 10 November 1997

## 2. Liberal Democrats

The Liberal Democrats have traditionally been the party with fewest reservations about entry into EMU. Paddy Ashdown gave this reaction to the Chancellor's announcement in October in a speech to the CBI:

[What is needed is] a recognition of how vital regionalisation is in the development of a global economy. Our region is Europe. We must be in there, shaping Europe, not speculating from the sidelines. The Liberal Democrats will use our influence in this Parliament to ensure that's what happens.

"That's why I welcome the clear declaration by the Government in favour of a single currency, and Britain's membership of it. I welcome less the hesitation and delay until after the next election. As St Augustine might have observed: 'Give me EMU, oh Lord, but not yet!'

"But this is a decision to be driven either by Britain's interest, or by Britain's electoral timetable. But it can't be both.

"Having made the decision in principle on monetary union, the Government will now, I believe, be pushed down this track faster than they are currently prepared to admit. And the Liberal Democrats will be one of the forces pushing them.

"We challenge those in all parties, and business too, who want to see Britain playing its full part in Europe to work together in defeating Euroscepticism and winning the case for Britain's constructive engagement in Europe."<sup>12</sup>

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<sup>12</sup> Liberal Democratic Party Press release, 10 November 1997

## IV The State of Convergence

### A. Introduction

This section of the Paper looks at which Member States meet the criteria for convergence on the basis of the 1997 economic data. Such an exercise should not be regarded as definitive since the actual procedure for assessing convergence is likely to be more flexible than this 'snapshot' approach, with trends over time being examined as well as the latest available data. This is illustrated by the Commission's relatively generous interpretation of Ireland's debt to GDP ratio under the excessive budget deficit procedure. Furthermore, the introduction of 15% bands of fluctuation for most of the currencies in the ERM and the accession of three new Member States, the application of the criteria on the observance of normal ERM fluctuation bands is particularly uncertain.

For the purposes of this analysis 1997 data has been used as published by either Eurostat or in other sources compatible with it. The criteria in the protocol (as amplified in the protocol on excessive budget procedure) are set out in the following notes that also describe the data chosen for this exercise. The results of the analysis are summarised in the table on page 24.

### B. The Convergence Test

#### 1. Achievement of Price Stability.

The convergence protocol states:-

*The criterion on price stability referred to in the first indent of Article 121(1) of this Treaty shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1½ percentage points that of, at most, the three best performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions*

The final harmonised price data have been in existence for two years now and are used for the first time. The Commission seems to suggest<sup>13</sup> that the preferred measure will be the average of the annual year-on-year average rate of inflation in the three Member States with lowest inflation and this approach has been followed here. The data used here are the average increases in the harmonised price index of each Member State during 1997. The three lowest inflation

<sup>13</sup>European Economy Supp A, January 1996

rates were Finland (1.2%), Austria (1.2%) and France (1.3%). The average of these three is 1.23% suggesting a threshold for this criterion (plus 1.5%) of 2.7%. Only Greece (4.5%) had an inflation rate above this level.

## 2. Government Deficits and Borrowing

The protocol states:-

*The criterion on the government budgetary position referred to in the second indent of Article 121(1) of this Treaty shall mean that at the time of the examination the Member State is not the subject of a Council decision under Article 104(6) of this Treaty that an excessive deficit exists*

The criteria that will be used by the Commission to identify an excessive deficit are set out in Article 101 of the Treaty. It states:

*(a) whether the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value, unless:*

- either the ratio has declined substantially and continuously and reached a level that is close to the reference value;*
- or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;*

*(b) whether the ratio of government debt to gross domestic product exceeds a reference value, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.*

The protocol on the excessive budget procedure states:-

*The reference values referred to in Article [101 (2)] of this Treaty are:*

- 3% for the ratio of the planned or actual government deficit to gross domestic product at market prices;*
- 60% for the ratio of government debt to gross domestic product at market prices.*

Performance against both parts of this criterion is based upon figures submitted by Member States in their presentation to the Commission in February 1998. The issue of whether the data are close enough to the reference levels or whether an excessive figure is declining sufficiently quickly towards the reference level has been ignored for the purposes of this Paper. The pass/fail judgement depends automatically upon a country being in excess of or beneath the reference levels.

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### 2(a). Government deficit

The data to be used for assessing the budget deficit are general government net borrowing (equivalent to the general government financial deficit) as defined in the European system of national accounts (ESA). In an almost complete change of fortunes since 1996, when all Member States except Denmark, Ireland, the Netherlands and Luxembourg had deficits in excess of 3%, now, by contrast, only France (but only marginally) and Greece have deficits in excess of 3% of GDP.

### 2(b). Government debt

Although the deficit/GDP ratios have declined, partly due to the general improvement in European economies over the past year, the debt criterion remains troublesome. Only France, Luxembourg, Finland and the United Kingdom are below the 60% of GDP threshold. However, both Ireland and Denmark have a derogation from the excessive deficit judgement and are treated as though they were under the reference level.

## 3. Observance of Normal ERM Fluctuation Margins.

The protocol states:-

*The criterion on participation in the Exchange Rate Mechanism of the European Monetary System referred to in the third indent of Article 121(1) of this Treaty shall mean that a Member State has respected the normal fluctuation margins provided for by the Exchange Rate Mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against any other Member State's currency on its own initiative for the same period.*

Ever since the widening of the fluctuation band to  $\pm 15\%$  in August 1993 following the general crisis in the system, the criterion has become extremely difficult to interpret. For example there is the obvious debate about what constitute 'normal' fluctuation bands. At one extreme, it could be argued that 15% is now the 'normal fluctuation margin' and that Member States need do no more than stay in the ERM to qualify. An alternative interpretation is that the normal margins are the original  $\pm 2\frac{1}{4}\%$  bands and hence most Member States, except currently the Netherlands and Germany fail on this criterion. Clarification of the official position came in the EMI's 1996 convergence report that noted that:

"In 1991, when the Treaty was conceived, the "normal fluctuation margins were  $\pm 2.25\%$  around bilateral central rates, whereas a  $\pm 6\%$  band was a derogation from the rule. In August 1993 the decision was taken to widen the fluctuation margins to  $\pm 15\%$ , and the interpretation of the criterion...became less straightforward. **On the other hand, the central parities remain unchanged and the requirement to be a member of the ERM remains an element of the Treaty.** The widening of the ERM bands created a new market environment...Account needs to

be taken of the particular evolution of exchange rates in the EMS since 1993 in forming an ex post judgement<sup>14</sup>"

Summarising its assessment under the exchange rate criterion the EMI concluded that:

"At this stage the EMI does not consider it appropriate to give a precise operational content to the measurement of exchange rate stability according to Article 109j of the Treaty, which could mechanically be applied also to forthcoming periods.....Regarding the Treaty provision of ERM membership, there is a strong majority position within the EMI Council according to which the requirement of ERM membership applies. This is also reflected in the analysis [in the Annual Report]. A minority take the view that exchange rate stability based on sustainable underlying economic fundamentals is more important than the institutional setting within which stability is achieved."<sup>15</sup>

For the purposes of this exercise, the test has been whether the Member State has been in the ERM for at least two years without devaluing. Five countries fail to meet this test, Greece, Italy, Finland, Sweden and the United Kingdom. However, since Finland and Italy joined in October November 1996, respectively, both countries will qualify by the end of this year and before the Stage 3 deadline. This is now a fairly undemanding test.

#### 4. Convergence of Interest Rates

The protocol states:-

*The criterion on the convergence of interest rates referred to in the fourth indent of Article 109j(1) of this Treaty shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best performing Member States in terms of price stability. Interest rates shall be measured on the basis of long term government bonds or comparable securities, taking into account differences in national definitions*

The analysis in the table is based on the averages of long-term interest rates for the last quarter of 1996, with the exception of Ireland and the Netherlands for which third quarter figures are used. Among those countries with the three lowest inflation rates (Finland, France and Austria) the average long-term interest rate was 5.1% suggesting a threshold of 7.6%. Only Greece had interest rates above this level.

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<sup>14</sup>*Progress Towards Convergence*, 1995, p33

<sup>15</sup>EMI Annual Report 1996 p 41

**C. Performance**

The performance of Member States according to the latest economic data is shown in the table below.

**Maastricht Convergence Criteria**

{A} Latest data						
	Inflation Rate (a) average % change in 1997	Interest rates average 1997	General government gross debt % of GDP	Surplus(+) Deficit(-) % of GDP	ERM membership for two years	
Belgium	1.5	5.59	122.2	-2.1	yes	
Denmark	2.0	6.23	64.1	0.7	yes	
Germany	1.5	5.53	61.3	-2.7	yes	
Greece	5.4	10.4	108.7	-4.0	no	
Spain	1.9	5.84	68.3	-2.6	yes	
France	1.3	5.67	58.0	-3.0	yes	
Ireland	1.9	6.49	66.3	0.9	yes	
Italy	1.4	6.55	121.6	-2.7	no	
Luxembourg	1.9	5.77	6.7	1.7	yes	
Netherlands	1.9	5.81	72.1	-1.4	yes	
Austria	1.2	4.79	66.1	-2.5	yes	
Portugal	1.9	6.36	62.0	-2.5	yes	
Finland	1.2	4.85	55.8	-0.9	no	
Sweden	1.9	6.61	76.6	-0.4	no	
United Kingdom	1.8	7.04	53.4	-1.9	no	
Reference value	2.7	7.10	60.0	3.0	2 years	

**{B} Performance**

	Inflation Rate (a) % change in year to December 1997	Interest rates average 1997	General government gross debt	Surplus(+) Deficit(-)	ERM membership for two years	
Belgium	pass	pass	fail	pass	pass	
Denmark	pass	pass	fail	pass	pass	
Germany	pass	pass	fail	pass	pass	
Greece	fail	fail	fail	fail	fail	
Spain	pass	pass	fail	pass	pass	
France	pass	pass	pass	fail	pass	
Ireland	pass	pass	fail	pass	pass	
Italy	pass	pass	fail	pass	fail	
Luxembourg	pass	pass	pass	pass	pass	
Netherlands	pass	pass	fail	pass	pass	
Austria	pass	pass	fail	pass	pass	
Portugal	pass	pass	fail	pass	pass	
Finland	pass	pass	pass	pass	fail	
Sweden	pass	pass	fail	pass	fail	
United Kingdom	pass	pass	pass	pass	fail	

Note: (a) Harmonised price data

Sources: ONS First Release, January 1998  
 OECD main economic indicators  
 EU Member States

On the basis of these data, only Luxembourg currently satisfies all the criteria. To this can be added Ireland and Denmark who have a pre-announced derogation in this respect. This is clearly at odds with the comments made generally in the press regarding a likely qualifying group of eleven Member States. The discrepancy is accounted for by the treatment of the debt criterion. Comment to the effect that there will be a large number of initial qualifiers clearly requires the Commission/EMI to interpret the criterion taking full advantage of the flexibility given in the Treaty.

The table below sets out likely groups of qualifying Member States according to different criteria, going from a very rigid, arithmetic approach, to a more judgmental approach making assumptions about future developments in the ERM.

**Performance against the convergence criteria**

'Strict', no flexibility interpretation	'Strict' but with pre-announced derogations	No debt criteria	No debt criteria plus ERM qualification by 1999
Luxembourg	Luxembourg	Luxembourg	Luxembourg
	Denmark	Denmark	Denmark
	Ireland	Ireland	Ireland
		Belgium	Belgium
		Germany	Germany
		Spain	Spain
		Netherlands	Netherlands
		Austria	Austria
		Portugal	Portugal
		Sweden	Finland
			Sweden
			Italy

On this range of assumptions the number of qualifiers ranges from one to eleven, but it is worth pointing out that this first eleven includes Denmark, which, like the UK, has an opt out from membership. Of the remainder, Sweden fails two of the five criteria (excessive debt and membership of the ERM) and Greece fails them all.

V Appendix – Euro notes



