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ECONOMIC AND MONETARY UNION: Transitional Issues and Third-Stage Dilemmas[1]

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The Commitment to EMU

At Cannes in June 1995, the heads of state and government of the European Union, meeting as the European Council, restated their firm resolve to move to the third and final stage of Economic and Monetary Union (EMU) by January 1, 1999, in strict accordance with the convergence criteria, timetable, protocols and procedures laid down by the Treaty on European Union. Meeting in Madrid six months later, the leaders made their commitment to moving to EMU even more explicit, "confirming unequivocally that stage three of economic and monetary union will commence on 1 January 1999." (*European Commission* 1995, p. 9.)

Despite the difficulties that many of the member states have encountered since those meetings in satisfying the criteria for entry to the third stage, the commitment remains intact. Despite recurrent speculation in financial markets and elsewhere about the wisdom of delaying the advent of stage three a year or two, we can be fairly confident that the EU will adhere to the provisions of Article 109j(4) of the Treaty and move to the third and final stage of EMU on the first day of 1999.

Armed with the European Monetary Institute's (EMI) "reference scenario," the EU is therefore now on a course that will result in:

> 1. The creation of a new European System of Central Banks (ESCB), consisting of a new European Central Bank (ECB) and the existing central banks of the member states. This system will assume full responsibility for defining and conducting the monetary policy and foreign exchange operations of the participating member states;
>
> 2. The irrevocable fixing of exchange rates and creation of a new single currency, the euro.[2]

The EU confronts many transitional issues as it moves toward EMU. It did, however, solve several of the most important problems in 1996. For example, it devised a new "hub and spoke" version of the Exchange Rate Mechanism that will link most, if not all, currencies of the member states which do not enter the final stage of EMU in 1999 to the euro. This mechanism will diminish exchange rate volatility and the temptation among the "outs" to pursue competitive devaluations (see Cameron 1996a.) And at Dublin in December 1996, protracted negotiations within the Council of Ministers and European Council [3] finally produced agreement on the contours of a so-called "stability pact" (later, at French insistence, renamed the "stability and growth pact"). This pact, its proponents hope, will assure continued fiscal responsibility and create a "stability culture" among the participants in the third stage.

Despite last year's agreements, the implementation of EMU raises a number of difficult and contentious issues. These issues concern both the transition to the third stage of EMU and the functioning of economic policy after the transition. This paper examines three of the most important transitional and post-transitional problems, namely:

1. Who will qualify for admission? The most important issue in the transition is clearly which member states will satisfy the "convergence criteria" described in the Treaty on European Union and thereby earn the right to participate in the third stage of EMU in 1999. The uncertainty surrounding this issue is compounded by the fact that the European Council will not decide which states will participate in the third stage until the spring of 1998, only months before it is to begin. [4]

2. How will EMU affect growth and employment? The issue here is whether member states who do qualify will be able to solve or reduce longstanding economic problems that afflict most of them. In particular, will EMU make it easier or harder for them to deal with the endemic problem of low economic growth and high unemployment? This question is all the more open because the Treaty, for all its elaboration of the structures and responsibilities of the ECB, does not provide an answer.

3. How, if at all, will economic policy be coordinated and conducted among the participant member states? Will these governments be able to exercise collective control of their economies? What degree of control will be left to them when they lose the ability to affect exchange rates and to set monetary and even fiscal policy?

We can do little more than guess about how these questions will be answered. What is probable is that these answers will be defined by and depend upon politics--that is, the choices of the leaders, ministers, and officials of the national governments of the member states operating within the institutional context of the EU.

The Transition to the Third Stage: Who Will Qualify?

The Treaty on European Union stipulates that the member states which move to the third stage of EMU must have achieved a "high degree of sustainable convergence." That means that each state has achieved, by the terms of Article 109j(1) and Protocol 6:

> 1. A "high degree of price stability" (apparent from a rate of inflation as measured by the change in consumer prices) that does not exceed by more than 1.5 percentage points that of the three best performing states;
>
> 2. An average nominal interest rate on long-term government bonds or comparable securities that does not exceed by more than two percentage points that of the three best performing states in terms of price stability;

3. Observance of the "normal" fluctuation margins of the Exchange Rate Mechanism of the European Monetary System for at least two years without "severe tensions" or a devaluation "on its own initiative"; and

4. A government budgetary position such that the state is not the subject of a decision by the Council of Ministers under Article 104c(6) that an "excessive deficit" exists.

Three of these "convergence criteria" - those pertaining to inflation, interest rates, and participation in the ERM - are quite straightforward and can be readily observed and measured. And if convergence were judged only by these three criteria, a significant number of member states seem to have already achieved the convergence necessary for adoption of a single currency. There would therefore be little doubt that the transition to the third stage of EMU could take place in 1999 (if not earlier).

Indeed, a *majority* of the member states do seem to have met the conditions required for entry to stage three of EMU, to judge by the most recent data for rates of inflation and long-term interest rates on government securities, and the recent experience of the ERM (presented in Table 1). Had "sustainable convergence" been defined only in terms of those three criteria, 9 nations - Belgium, Denmark, France, Germany, Ireland, Luxembourg, the Netherlands, Austria, and Finland [5] - would qualify for stage three on the basis of 1996 data and two others - Spain and Portugal - would come very close to qualifying. [6] Even Italy, which (after Greece) had the highest rate of inflation in the EU, would be within hailing distance after having rejoined the ERM in November 1996. [7]

But the criteria based on inflation, interest rates, and participation in the ERM are not the only ones specified by the Treaty. The fourth criterion, which stipulates that a member state not be the subject of a Council of Ministers decision that an "excessive deficit" exists, is more problematic.

What is an "excessive deficit?" By the terms of Article 104c and Protocol 5, an "excessive deficit" may exist when either:

1. The ratio of the planned or actual general government deficit (that is, the combined deficit of all levels of government, including social security funds) to Gross Domestic Product exceeds three percent. However, this requirement may be relaxed if the ratio has declined "substantially and continuously and reached a level that comes close" to that figure or, alternatively, if the excess over that figure "is only exceptional and temporary and the ratio remains close" to that figure); or

2. The ratio of government debt to GDP exceeds 60 per cent, "unless the ratio is sufficiently diminishing and approaching [that figure] at a satisfactory pace."

Application of these criteria is not automatic. A member state becomes the subject of a Council of Ministers decision that an "excessive deficit" exists if the Commission considers that to be the case (or a possibility), addresses an opinion and recommendation to the Council to that effect, and the Council, after "having considered any observations which the Member State concerned may wish to make" and "after an overall assessment," decides, by qualified majority, to accept the Commission's recommendation.

The primary reason for uncertainty about the future of EMU is uncertainty about how many member states satisfying the first three criteria will also satisfy the "excessive deficit" criterion when decisions have to be made in 1998. At present, the Council of Ministers (acting in accordance with Article 104c(6) of the Treaty) has named only three member states - Denmark (as of June 1996), Ireland, and Luxembourg (the latter two as of September 1994) - as not having an "excessive deficit." [8] (In July 1995, the Council concluded that Germany did not have an "excessive deficit" but in June 1996 it rescinded that decision.)

If current projections of the ratios of deficits and debt to GDP hold, 9 other member states are likely to meet the convergence criteria for inflation, interest rates, and ERM participation, but will probably find that either their deficit-to-GDP ratio or their debt-to-GDP ratio (or both) exceed the reference values specified in the Treaty. [9] The OECD's most recent forecasts of the 1997 deficit and debt ratios for the EU member states (presented in Table 2) suggest that several member states - Belgium, the Netherlands, Austria, Finland, and Portugal - will have 1997 deficits of less than three per cent of GDP, but will also have a stock of public debt equivalent to more than 60 percent of GDP.

The Council of Ministers has some discretion that may work to the benefit of these states. In its earlier decisions regarding Ireland and Denmark, it waived the debt criterion in cases where the deficit was well under three per cent of GDP and the stock of debt was decreasing relative to GDP. If it applied this rule again, all of the 9 (with the possible exception of Belgium) might be judged not to have an "excessive deficit." [10]

But the situation may be more problematic for Germany, France, and Spain. In all three, the 1997 deficit is likely to be *greater* than three per cent (3.2 percent in France and 3.4 per cent in Germany and Spain). The French and Spanish governments, however, have cut their deficits significantly in recent years (from 4.8 percent in 1995 in France and from 6.6 percent in 1995 in Spain). [11]

Italy's situation is far more problematic. Facing deficits of 7.1 percent of GDP in 1995 and 6.7 percent in 1996, the Prodi government proposed in 1996 cutting the deficit by some 62 trillion lire, specifically in order to reach the EU's target of three per cent by 1997. [12] By early 1997, the Bank of Italy estimated that without another 15 trillion in revenues or expenditure cuts, the 1997 deficit would be 3.8 per cent of GDP. Moreover, the stock of public debt continued to be in excess of 120 percent of GDP - far above the levels found in the other large member states.

Thus even France and Germany may not satisfy all of the convergence criteria, while most other member states have a deficit problem. [13] The uncertainty that this prospect creates is aggravated by the complex and ambiguous procedure by which decisions are made about whether deficits are "excessive." The Commission is supposed to monitor the budgetary situation and the stock of government debt in each state (in particular, the state's " compliance with budgetary discipline").

According to Article 104c, it must then determine whether member states satisfy one or both of the criteria referring to deficits and government debt.

That determination will inevitably involve discretionary judgments about such issues as whether the deficit has declined "substantially and continuously," what level is "close" to three per cent, and what constitutes an "exceptional and temporary" excess. [14] Concerning public debt, the Commission will have to judge what constitutes a "sufficiently diminishing" ratio, what constitutes a "satisfactory pace," and what "approaching" means. All of these terms - "close," "substantially and continuously," "exceptional and temporary," "sufficiently diminishing," and " satisfactory pace" - obviously connote discretionary judgment, rather than specific and precise figures.

If, after an assessment of the deficit and debt ratios in the light of these ambiguous terms, the Commission decides that an "excessive deficit" exists, it must address an "opinion" to the Council of Ministers. But the Treaty at no point specifically defines an "excessive deficit." While the language implies that the two budgetary criteria described above define "excessive deficits," the Treaty in fact describes them only as "criteria" by which "compliance with budgetary discipline" can be "examined." Therefore, whether a deficit is " excessive" depends not on the specific deficit and debt figures but rather upon the discretionary judgment of the Commission.

Finally, even if the Commission renders an opinion that an "excessive deficit" exists, it is still up to the Council of Ministers to decide whether the deficit in question is excessive. [15] To make matters even more complex, the European Council, in its deliberations on which states have satisfied the convergence criteria, will have before it two reports - one from the Commission, the other from the EMI - that examine the admissibility of individual member states. [16] It will also have before it a recommendation from the Council of Ministers on each member state. The European Council will then decide - by qualified majority vote - on the overall qualifications of member states.

This complex and ambiguous procedure clearly generates the greatest possible uncertainty about the outcome. Its complexity and the great scope for discretionary judgments also create latitude for the play of political influence. Such latitude for discretion is expanded by the precedents for waiving a Treaty-defined "convergence criterion" set by the decisions on Denmark and Ireland. Some of the member states that miss one (or possibly, as in the case of Germany and Spain, both) of the budgetary criteria may, therefore, for *political* reasons, be judged to be qualified for participation in the final stage of EMU in 1999. More concretely, that latitude for discretion, coupled with the precedents already created in regard to the debt criterion and the likelihood that political factors will enter into the decisions, suggests that something of a logroll may ensue. As a result, a *large* number of states - probably 8 and perhaps as many as 10 - will be judged worthy of participation in the third stage in 1999, despite predictions based on current data.

After all, if two states have already benefited from a waiver of one of the "convergence criteria," can others with roughly comparable deficit and debt ratios be denied the same indulgence? And if one of the criteria has already been waived, can a waiver of some *other* criterion - e.g., the one pertaining to the deficit ratio - be denied? Thus, just as the Council of Ministers decided that Denmark and Ireland did not have "excessive deficits," despite debt ratios well above 60 per cent, so too the European Council may decide in 1998 (voting by qualified majority) that France, Germany, Belgium, the Netherlands, Austria, Finland, Spain, and Portugal (as well as Denmark, Ireland, and Luxembourg) all have achieved the "high degree of sustainable convergence" required for the adoption of a single currency, despite deficit and/or debt ratios in 1997 that are slightly larger than the reference values stipulated in Protocol 5 of the Treaty. [17]

For those who imagine that such a decision would violate the terms of the Treaty, it is useful to recall the words of one who knows that treaty well. In the words of Jacques Delors:

> *When one reads the treaty carefully, one sees that it allows for a nuanced interpretation .... We must read with great care a treaty which was cleverly drawn up and which leaves a margin for judgments of a political nature by the whole group of countries that want to join EMU.* [18]

It will, of course, be important for the member states wishing to enter the third stage of EMU in 1999 to demonstrate, in their budgetary and fiscal policy in 1997, a commitment to satisfying the "convergence criteria." And, of course, prior to the actual decisions in 1998 about participation in stage three, all of the relevant actors undoubtedly will continue to insist on the inviolability of the criteria.

But no one should be surprised if - given the ambiguities and the complexity of the qualification process - a relatively large number of member states (possibly 8 to 10) end up entering the third stage in 1999, notwithstanding the fact that several may have deficit and/or debt ratios larger than those described in Protocol 5. The ultimate decision lies, after all, with the European Council, a collection of heads of state and government, not with the Council of Ministers, with all the shifts in emphasis from the strictly financial toward the political and diplomatic that this difference in responsibility implies.

Economic Policy in the Third Stage: Will EMU Cure Low Growth and High Unemployment?

Article 2 of the Treaty on European Union commits all of the member states to promoting

> *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 of social protection....*

The countries moving to the third stage of EMU may find it difficult to live up to this commitment. They will find themselves without some of the traditional instruments of macroeconomic management. Exchange rates will be irrevocably fixed, and monetary policy will be under the control of the ECB. Fiscal policy will be constrained by the "excessive deficits" criterion of the Treaty and by the sanctions on such deficits stipulated in the "stability and growth pact." The homogeneity demanded by membership of EMU will make it all the harder for individual governments to respond to shocks that may affect particular regions and/or countries more than others. Such shocks, and national governments to cope with them, may jeopardize attainment of the EU's overall goals - especially those of "balanced development," "sustainable growth," "convergence of economic performance," and a "high level of employment." Member states are likely to find it even more difficult to respond to a larger, more intractable problem - the sclerotic performance of their economies over the long term.

With few exceptions (Ireland in terms of growth, Luxembourg in terms of unemployment), the EU has become an area of low economic growth and high unemployment during the 1990s. It is likely to remain in this condition after 1999. Even more ominously, even when the rate of growth recovers after cyclical downturns (as it may in 1997), the level of unemployment remains at high levels.

Employment has thus become (to some extent) uncoupled from the rate of growth. Indeed, most of the member states of the EU (and particularly those which are most likely to move to the third stage of EMU in 1999) seem to be locked into historically high rates of unemployment. As the data in Table 3 suggest, France, Belgium, Ireland, Finland, and Spain - all likely participants in the third stage of EMU - are expected to have unemployment rates of 12 percent or more in 1997. And in Germany, where the rate of unemployment is projected to be above 10 percent for 1997 as a whole, the seasonally unadjusted rate of unemployment soared above 12 percent in the first month of the year. [19]

Those in favor of EMU have argued that eliminating exchange rate uncertainty through the creation of a single currency will reduce transaction costs within the single market. Also, it will (they claim) increase the risk-adjusted rate of return on investment, which will stimulate higher levels of investment. This in turn will raise the rate of growth and help to reduce unemployment.

Moreover, EMU will (advocates argue) help to keep down interest rates. Low inflation in the member states participating in EMU, the improvement of their public finances, and the credibility of their commitment to maintain those policies for the foreseeable future will allow interest rates to be lower than at present. This will further stimulate investment, growth, and employment.

Such assumptions are quite plausible. But participation in EMU may well not have any of these beneficial consequences. Indeed, the assumptions themselves may be wrong.

Take first the belief that use of a single currency will eliminate transaction costs that would otherwise prevent investment. This assumption is implausible, since most if not all major investors have long since learned the fine art of hedging as a means of reducing the uncertainty associated with transactions in multiple currencies. Indeed, most major international economic actors - including, almost certainly, those accounting for the vast bulk of investment in the EU - routinely conduct transactions in the various EU currencies.

Take, secondly, the belief that low rates of inflation, small public deficits, and public commitment to those policies will enable the EMU participants to enjoy lower interest rates. They may, indeed, enjoy such interest rates. But their monetary policy will be under the control of a central bank that will be free of political instruction, singularly committed to maintaining price stability, and intent on keeping interest rates high enough to prevent inflationary increases in the money supply and depreciation of the value of the euro even at the cost of low growth and high unemployment.

Moreover, for the sake of its own credibility, the ECB will probably be especially stringent in carrying out such a policy in its early years. During this period, its officials will be concerned with establishing the bank's credibility as the guardian of the value of the euro, not only with the markets, but also with the national publics, which, with some considerable skepticism, agreed to "lose their money."

Interest rates under the aegis of the ECB may be lower than a weighted average of the current rates in the member states participating in the third stage. But it is more likely that a central bank, which by its founding statute (Protocol 3 of the Treaty) will be politically independent and committed to maintaining stable prices, will maintain rates in such a way as to prevent inflationary increases in the money supply, even at the cost of low growth and high unemployment.

EMU participants might seek to alleviate the pattern of relatively low rates of economic growth and high levels of unemployment by managing the external exchange rate of the euro *vis-à-vis* other currencies. By stabilizing the external exchange rate or otherwise keeping it from appreciating vis-à-vis other currencies such as the dollar and the yen, they might conceivably provide a price advantage for "euro- zone" exports and make externally produced goods less competitive *within* the "euro-zone." Such a strategy would boost growth and presumably create or maintain jobs within the zone. And indeed Article 109.1 of the Treaty on European Union does authorize the Council of Ministers to conclude formal agreements on an exchange rate system with non-EU currencies and to adjust or abandon the rate of the euro in such systems. Further, Article 109.2 provides that, in the absence of such a system, the Council of Ministers may formulate "general orientations" for exchange rate policy with non-EU currencies.

But the Treaty places certain constraints on the Council of Ministers in regard to the external exchange rate, which might inhibit it from pursuing a strategy of competitive devaluation. Article 109.1 stipulates that the Council of Ministers must act unanimously, must act upon a recommendation from the ECB or the Commission, and must consult with the ECB "in an endeavor to reach a consensus consistent with the objective of price stability." And in regard to the formulation of "general orientations," the Council must act, by qualified majority, upon the recommendation of the Commission, followed by consultation with the ECB, or upon the recommendation of the ECB. And as with the agreements described in 109.1, these "orientations" must be "without prejudice to the primary objective of the ESCB to maintain price stability."

Given the constraints specified in Article 109, the consultative role provided for the ECB in exchange rate policy, and the admonition to adhere to the objective of price stability, it is clearly more likely that the participating member states will obtain little or no relief from their condition of low growth and high unemployment through manipulation of the exchange rate of the euro.

Indeed, if anything, we might predict that the euro would be allowed to float and to appreciate vis-à-vis non-EU currencies, just as its closest antecedent, the German mark, has floated and appreciated over the past decade. Such floating would be consistent with the ECB's guidelines and would occur regardless of adverse effects that it would have on the competitive position of member states in export markets, on their balance of trade, and, at home, on growth and employment. [20]

Lest there be doubt about that, it is perhaps useful to cite what one of the principal architects of EMU has to say about the relative importance of domestic price stability and exchange-rate stability:

> *The Bundesbank always decided in favor of domestic price stability and sacrificed exchange-rate stability if necessary.... The Bundesbank, I assume, is much happier [after the 1992-93 ERM crisis] living with a de facto floating system, with practically no intervention obligations for the time being, than with a system of fixed but adjustable exchange rates, which [has been] accurately called "half-baked" because adjustments never take place at the right moment....The mandate of the ECB must be to maintain stability of the value of money as the prime objective of European monetary policy...Domestic stability of the value of money must take precedence over exchange-rate stability.* [21]

If the preference for domestic price stability to exchange-rate stability that Karl-Otto Pöhl describes is typical of all central bankers, it is probably also true that the Governing Council of the new ECB will be especially sensitive to the same priorities in its early years, as it attempts to establish credibility for itself and for the euro by demonstrating its commitment to maintaining stable prices.

The euro, like its predecessors that remained in the ERM after 1992-93, is thus likely to be a strong currency relative to others such as the dollar and the yen. It will probably be allowed to float and to appreciate, even at the cost of continued losses of export markets and, in turn, of production, jobs, and income at home. This outcome is all the more likely since the EU has gone to such lengths to immunize the ECB from those - exporters, workers, governments - who might prefer an undervalued currency that would give exports a competitive advantage to the alternative of maintaining stable prices.

Moving to the third stage of EMU and irrevocably locking exchange rates may have salutary consequences - perhaps the most important being the elimination of the instability and fluctuation among the European currencies that occurred every time the D-Mark increased in value against the dollar. But it will probably do little to improve the competitive position of the "euro-zone" in the world and provide an export-based boost to growth and employment. Indeed, if anything, the constraints operating on the external exchange rate of the euro may actually contribute to a *deterioration* in the competitive position of the economies of those participating member states in global markets, thereby accentuating the pattern of low growth and high unemployment at home that already characterizes so much of Europe.

This prospect is bound to have political as well as economic consequences. Citizens will blame their own governments for the lack of growth and continued unemployment, but they may also blame the EU in general and the EMU project in particular. The foundation of public support upon which EMU ultimately rests has *already* eroded significantly. Indeed, if one were to extrapolate from recent experience, it is quite conceivable that some of the governments in member states that can be expected to participate in the third stage of EMU may, at some point in the not-too-distant future, find themselves confronted by significant numbers of voters who have concluded that the costs of EMU exceed the benefits.

Tables 4 and 5 present the results of Eurobarometer surveys conducted in the member states of the EU. The data in Table 4 reveal that widespread erosion occurred in the 1990s in the extent to which citizens of the EU member states believed their country had benefited from membership in the EU. For example, [compared with the situation in late 1991] those data suggest that the distribution of public opinion between those believing their country had benefited from membership in the EU and those believing it had not shifted markedly toward the negative in all but one (Ireland) of the member states.

In some countries - notably, Belgium, Spain, Portugal, France, and Germany - the erosion in support for the EU has been dramatic. Admittedly, as of late 1995, public opinion in 8 of the fifteen member states appeared, on balance, to believe that the country *had* benefited from membership. But in the other 7 member states - Germany, France, Spain, and Britain, and the three 1995 entrants - roughly as many, or more, citizens felt their country had *not* benefited from membership as thought it had. [22] In sum, the European public appears to be deeply divided over, and skeptical about, the value of membership in the Union - perhaps more so than at any time since Eurobarometer began asking the question in the early 1980s.

The same Eurobarometer data reveal a substantial degree of opposition to the single currency, the feature that, in the view of the European public, is perhaps the most salient aspect of EMU. In late 1995, close to a majority (47 percent) of the EU public supported introduction of the single currency (see Table 5). But a substantial minority (33 percent) did not. And in at least 6 member states - Germany, Finland, the United Kingdom, Denmark, Austria, and Sweden - more people opposed than supported the single currency.

Who Will Make Economic Policy in the Third Stage?

The discussion in the preceding section raises the fundamental question of whether the member states that participate in the third stage of EMU will be capable of addressing the enduring problems of low growth and high unemployment in the EU. This question represents a larger issue of institutional design and governance that confronts the EU in regard to EMU and that will continue to confront the member states, which participate in the third stage. The answer to the question depends on whether the member states participating in the third stage of EMU will have the institutional capacity and authority to conduct economic policy. The Treaty on European Union is far from encouraging in that regard. Article 102a commits all of the member states, including those participating in the third and final stage of EMU, to conducting their economic policies with a view to achieving the objectives of the Community as described in Article 2 ("harmonious and balanced development," "sustainable growth," "convergence of economic performance," and a "high level of employment," etc.). Article 103.1 stipulates that the member states will regard their economic policies as a matter of "common concern" and shall "co-ordinate them within the Council [of Ministers]...." Article 103.2 stipulates that the Council, acting by qualified majority on a recommendation from the Commission, shall "formulate a draft for the broad guidelines of the economic policies of the member states and the Community," and that the European Council will then "discuss a conclusion on the broad guidelines" that will, in turn, become the basis for a Council "recommendation setting out these broad guidelines."

The language of these Articles - the use of such phrases as "common concern," "co-ordinate ... within the Council," "formulate a draft," "broad guidelines, " "discuss a conclusion," and "recommendations setting out these broad guidelines" - indicates that the Treaty creates no new authority or competence in the field of economic policy. It sets up no new institutional body in the area of economic policy that would include only the member states participating in the third and final stage of EMU. It creates no new competences or policy instruments for use by participating member states in the realm of economic policy. Instead, the Councils, composed of the representatives of all of the EU member states, will simply formulate guidelines, discuss conclusions, and make recommendations based on those guidelines and conclusions.

Just how far the Treaty fails to create the authority and institutional capacity by which member states could act collectively in the domain of economic policy becomes most obvious when the cursory language of Article 103 is juxtaposed with the extensive discussion in Articles 105-109 and Protocols 3 and 4 pertaining to monetary policy, the ESCB, and the ECB. In a single-minded effort to create a strong independent central bank, the authors of the Treaty ignored a simple and obvious fact of political life - which no central bank, independent or otherwise, has ever, or could, operate without a political counterpart that is responsible for shaping the overall contours of economic policy.

Some voices within the EU have recognized the need for such a political counterpart once the third stage of EMU has begun. President Jacques Chirac, for example, has called several times for a political force to offset the power of the ECB -- precisely such a "political counterpart." [23] In mid-December 1996, the French minister of finance, Jean Arthuis, repeated the French call for the creation of some institutional form - perhaps, he suggested, a council for stability and growth composed of the representatives of the member states participating in the third stage of EMU - to act as a political counterweight to the ECB.

Not surprisingly, the central bankers have reacted negatively to these proposals. Hans Tietmeyer, the President of the German Bundesbank, has denounced the effort to create a *pouvoir politique* and has warned that such an effort does not conform to the Treaty. Nevertheless, the French government continues to advocate creation of such a council, and in February 1997 it received the endorsement of Jacques Delors, who suggested that a protocol be added to the Treaty allowing for the creation of a council to coordinate macroeconomic policy. [24]

At a meeting of the finance ministers and heads of the central banks of France and Germany in Lyon in March 1997, the German officials appeared to shift their position to one of qualified support for the French proposal for a "stability and growth" council, composed of the finance ministers of the member states participating in the third stage, which would coordinate economic policy. This shift occurred, apparently, after the French officials had assured the Germans that the proposed council would be informal, would concern itself with economic policy and not monetary policy, and would not intrude upon the independence of the ECB. [25] However, several days later, at a meeting of the fifteen finance ministers, the Council of Ministers, while accepting the idea in principle, indicated that the proposed body would have little power, would not act as a "political counterweight" to the ECB, and would not possess responsibility for exchange rate policy (which would remain in the hands of the full Council of Ministers, as opposed to the ministers of the Stage Three participants). [26] These efforts to water down the original French proposal suggest that it is unlikely that any "counterweight" will be created prior to the advent of the third stage. As low growth and high unemployment continue to afflict economic life in the EU after 1999, as they almost certainly will, citizens and governments of the member states participating in the "euro-zone" will almost certainly ask, even more frequently than they do now, who makes economic policy in the EU and why the EU is unable to achieve higher rates of growth and reduce the high levels of unemployment. And the asking of those questions will almost certainly lead, in turn, to renewed calls for the creation of precisely that *pouvoir politique* that is now absent and that the finance ministers are so reluctant to endorse.

Conclusion

This paper has considered two kinds of issues facing EMU. One concerns qualifications and membership: how qualifications are evaluated and which member states are likely to meet the criteria set for membership in the third stage of EMU in 1999. The other concerns the capacity of member states, individually and collectively, to deal with economic policy after the advent of the third stage. In particular, will they be able to address the long-term problems of low growth and high unemployment that afflict so much of Europe?

In regard to the first issue, the paper suggests, for supporters of EMU, some reason for optimism. It is very likely that the third stage of EMU will begin on the first day of 1999 and also that the "euro-zone" that comes into being on that day will, in all likelihood, include a *large* number of member states - almost certainly as many as 8 and probably as many as 10 or 11. This outcome is likely because of

> a) the complexity of the process by which the qualifications of the member states for participation in the third stage will be assessed;
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> b) the latitude for discretionary judgment accorded by the Treaty;
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> c) the existence of precedents for waiving certain of the "convergence criteria"; and
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> d) the fact that the final decision will be made by the European Council, rather than the Council of Ministers.

On the second issue - the capacity of EMU to address the long-term problems of low growth and high unemployment - the paper suggests some reason for concern and pessimism. Most of the member states participating in the third stage of EMU are likely to continue experiencing low growth and high unemployment. Neither monetary policy nor exchange rate policy is likely to be applied so as to generate any significant increase in the long-term rate of economic growth or any *de*crease in the high levels of unemployment that now exist in most of the likely "euro-zone" members. Moreover, the Treaty creates no institutional capacity for collective action in economic policy that might enable the member states participating in EMU to redress those problems, and there seems to be little desire in the EU as a whole to create that institutional capacity.

NOTES

[1] Earlier versions were presented at the workshop on "Supranational Governance: The Institutionalization of the European Union, Center for German and European Studies", University of California, Berkeley, November 1996; the Team Europe Retreat of the European Union Delegation of the European Commission, Washington, D.C., March 1997; and the Annual Meeting of the Inter-American Development Bank, Barcelona, Spain, March 1997. back to text

[2] At Madrid, the European Council adopted the EMI's "reference scenario" for the phase-in of the single currency, and phase-out of national currencies, by mid-2002. For the scenario, see EMI 1995. For the Council's decision, see European Commission 1995, 24-28. back to text

[3] "The Council of Ministers (or simply Council) represents the member state governments. The Council is composed of members state ministers: depending on the matter under discussion, either the ones responsible for specific policy areas (environment, transport, treasury) or the foreign ministers for general affairs.... The Council decides unanimously on major policy decisions as laid down in the treaty provisions, and in principle decides with a qualified majority on ... some matters ... [such as] ... the decisions about provisions to implement the decisions taken in unanimity....

The European Council is a special meeting of the Council of Ministers, in which the representatives of the Member States are the political heads of governments themselves (13 PMs and the Presidents of France and Finland, plus their PMs if in a situation of "cohabitation"). The Foreign Ministers and three members of the Commission, including its President, also participate. The European Council should not be confused with the Council of Europe which is a totally separate international organization independent of the EU.

The European Council convenes twice a year.... Its meetings and statements are often very important in providing political impetus or laying down guidelines in areas of prime importance to the EU, but it leaves the day-to-day legislative work to the ordinary Council meetings".

From EU Basics (http://eubasics.allmansland.com/), edited by Roland Siebelink with the help from Bart Schelfhout, Version 2.3.1., 25 March 1996. back to text

[4] In March 1997, the Commission proposed a timetable for the 1998 decision according to which it and the EMI would make their recommendations by mid-March 1998 and, after 6 weeks of consultation with national parliaments and the European Parliament, the European Council would make the final decision at a meeting in the United Kingdom by the end of April 1998. See Financial Times, 1-2 March 1997, p.2 back to text

[5] Finland after the markka's entry into the ERM in October 1996. back to text

[6] By February 1997, the annual rate of change in consumer prices in Spain had decelerated to 2.5 percent. If sustained, that would almost certainly allow Spain to satisfy the >convergence criterion= pertaining to the rate of inflation. See Financial Times, 14 March 1997, p.3. back to text

[7] In March 1997, the Commission issued the first set of "harmonized" rates of inflation for the EU. The data for the 12-month period through January 1997 indicate that all of the member states except Spain, Portugal, and Greece would satisfy the Treaty criterion (and Spain and Portugal missed by only 0.1 per cent). Although flawed by its omission of health, education, and home ownership costs, the "harmonized" rate will be used in the 1998 decisions in assessing compliance with the Treaty criterion. See Financial Times, 8-9 March 1997, p.2. back to text

[8] The decision in regard to Denmark reflected the fact that, as the EMI has noted (1996, 21), the gross debt for the country includes assets held by the Social Pension Fund against sectors outside the general government, government deposits at the central bank for management of the country's foreign exchange reserves, and amounts outstanding in government debt from financing of public undertakings. Excluding those funds from the calculation reduces the debt/GDP ratio to a range of 50-55 per cent. Despite the rationale, Germany formally objected to the decision. back to text

[9] The 9 include Belgium, France, Germany, the Netherlands, Austria, Finland, Portugal, Spain, and (possibly) Italy. back to text

[10] In 1997, the Belgian public debt is projected to be 127 per cent of GDP. There are, however, two reasons (in addition to the obvious one pertaining to the importance of Brussels for the EU) why Belgium may nevertheless be exempted from an "excessive deficit" judgment. For one thing, because its public debt is largely held domestically, the debt could be judged to have little impact on its neighbors. Second, because Belgium has a currency union with Luxembourg, even if it does not join stage three, as long as Luxembourg joins, the Belgian franc will, in effect, be irrevocably locked *vis-à-vis* the currencies of the stage three participants and the euro (without Belgium having the right to sit on the Governing Council of the ECB). In such circumstances, it is quite plausible that the European Council, if not the Council of Ministers, will grant Belgium an exception to the "excessive deficits" criterion, provided its 1997 budget deficit does not exceed three percent. back to text

[11] The stock of public debt in the three countries in 1997 is estimated to be 57 percent in France, 63 percent in Germany, and 69 percent in Spain. At the meeting of finance ministers on 17 March 1997, Theo Waigel indicated that Germany would seek a flexible interpretation of the Treaty that would exempt it from the 60 per cent criterion, on the grounds that the increase in Germany's debt/GDP ratio in recent years reflected the exceptional circumstances of German unification and the privatization of the railways. See Financial Times, 18 March 1996, p.20. back to text

[12] The deficit reduction would be achieved by reductions of 25 trillion lire in expenditure, increases of standard revenue of 12.5 trillion lire, a further 12.5 trillion lire yielded by a "Euro" tax, and another 12 trillion lire derived from "Treasury operations." back to text

[13] Whereas in 1996, most attention was concentrated on the question of whether France would meet the three per cent deficit criterion, by early 1997 attention had shifted to the distinct possibility that Germany would not meet that criterion, and the possibility that stage three would either have to be delayed until Germany could participate or would occur without Germany. back to text

[14] It was, of course, precisely this ambiguity that Germany sought to redress in its proposal for a "stability pact" that would, for purposes of deciding whether an "excessive deficit" exists, define "exceptional circumstances" with a specific figure relating to the magnitude of the decline in GDP. Yet, interestingly, even after long and protracted bargaining at Dublin had narrowed the application of "exceptional" to annual declines in GDP of at least 2 percent, the final language included the phrase "as a rule." And Commission and Council discretion remains in the case of declines in the range of 0.75 to 2 percent. See Conclusions of the Presidency, Dublin, December 1996. back to text

[15] See Article 104c(6) of the Treaty. back to text

[16] See Article 109j. back to text

[17] Denmark negotiated an "opt-out" from the third stage, which appears in Protocol 12 of the Treaty. After the Danish electorate rejected the Treaty in the referendum of 2 June 1992, Denmark negotiated a package of clarifications and "opt-outs" as the necessary condition for scheduling a second referendum. At the conclusion of that negotiation at the Edinburgh meeting of the European Council in December 1992, Denmark gave notice that it would not participate in the third stage. back to text

[18] *Financial Times*, 19 April 1996, p.2. back to text

[19] *Financial Times*, 2 February 1997. In February, the seasonally unadjusted rate rose by 13,000, to 4.67 million, or 12.2 percent of the work force. See Financial Times, 7 March 1997, p.16. back to text

[20] See the chart accompanying Samuel Brittan, "Right rate for the franc," *Financial Times*, 12 September 1996, p.12. Kenen 1995, 111-12, notes that until the single currency replaces the national currencies (by July, 2002 at the latest), foreign exchange traders are likely to use the mark as a proxy for all of the currencies that are, as of January 1, 1999, irrevocably locked. back to text

[21] Karl-Otto Poehl, "International Monetary Policy: A Personal View," in Gaidar and Poehl 1995, pp. 61, 67, 109. back to text

[22] Cameron 1996b, Table 13.4, reports consistently strong inverse correlations across the member states of the EU between the level of unemployment and the proportion of the EU national publics believing their country has benefited from membership in the EU. There are also strong positive correlations between the magnitude of the increase in unemployment in the early

1990s and the magnitude of the erosion in the proportion believing their country has benefited from membership. back to text

[23] Most recently at his meeting with Chancellor Helmut Kohl in Nuremberg before the December 1996 meeting of the European Council in Dublin. back to text

[24] On the comments by Chirac, Arthuis, Tietmeyer, and Delors, see, respectively, Financial Times, 10 December 1996, p.16; 17 December 1996, p.1; 20 January 1997, p.1 and 28 February 1997, p.2. back to text

[25] See *Financial Times*, March 13, 1997, 16. back to text

[26]See *Financial Times,* 19 March 1997, p.2. back to text

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Table 1
The Convergence Criteria for the Third Stage of EMU: Performance of the Member States of the EU in 1995-96 in regard to Inflation, Interest Rates, and Participation in the ERM

Participation in the ERM		Inflation (% Change, cpi)		Interest Rates (Long-term govt. securities) w/o "tension" or devaluation	
		1995	1996	1995	1996
Belgium	Yes*	<u>1.5</u>*	2.1*	7.4*	6.3*
Denmark	Yes*	2.1*	2.1*	8.3*	7.1*
Germany	Yes*	1.8*	1.5*	6.8*	6.1*
Greece	No*	9.3*	8.5	17.3	...
Spain	Yes**	4.7	3.6	11.0	8.2*
France	Yes*	<u>1.7</u>*	2.0*	7.7*	6.5*
Ireland	Yes*	2.5*	1.7*	8.3*	7.4*
Italy	Yes**	5.4*	4.0	11.8*	9.0
Luxemburg	Yes*	1.9*	<u>1.3</u>*	7.6*	6.6*
Netherlands	Yes*	1.9*	2.0*	7.2*	6.5*
Austria	Yes**	2.3*	1.8*	6.5*	5.3*
Portugal	Yes**	4.1	3.1	11.4	8.6*
Finland	Yes**	<u>1.0</u>*	<u>0.6</u>*	7.9*	6.0*
Sweden	No	2.9*	<u>0.5</u>*	10.2	8.0*
U.K.	No	3.4	2.4	8.2*	8.1*

*** Satisfies criteria stipulated in Article 109j and Protocol 6: For inflation, a rate that does not exceed by more than 1.5 percentage points the average of the three lowest (underlined). For interest rates, a rate that does not exceed by more than 2 percentage points the average of the rates in the three countries with the lowest inflation rates. For the ERM, state has respected the "normal" fluctuation margins without severe tensions for at least the last two years without a devaluation made on its own initiative.**

**** The Spanish peseta participates in the ERM but was devalued in March 1995. The Portuguese escudo was devalued at the same time but the initiative for the devaluations is generally seen as having come from Spain. The Austrian schilling joined the ERM in January 1995. The Finnish markka joined in October 1996. The Italian lira rejoined in November 1996.**

Source: IMF 1997, p. 69; OECD 1996, pp. A19, A39; 1997, p. 27. The 1996 rates of inflation for Denmark, Luxembourg, the Netherlands, Austria, Portugal, and Sweden are for 11 months, as are the 1996 interest rate figures for Ireland, Italy, and the Netherlands.

Table 2
The Budgetary Criteria for the Third Stage of EMU:
Government Deficits, Public Debt, and "Excessive Deficits," 1995-97

General Council Decision that "Excessive Deficit" Exists		Government Deficit/GDP			Public Debt/GDP		
		1995	1996	1997e	1995	1996	1997e
Belgium	Yes (9/94)	4.1	3.2	2.9*	133.7	129.9	127.2
Denmark	No (6/96) Yes (9/94)	1.6*	1.5*	0.4*	71.9	71.9	70.4
Germany	Yes (6/96) No (7/95) Yes (9/94)	3.5	4.1	3.4	58.1*	61.3	63.2
Greece	Yes (9/94)	9.1	8.2	5.7	111.8	108.5	104.5
Spain	Yes (9/94)	6.6	4.8	3.4	65.8	68.0	68.9
France	Yes (9/94)	4.8	4.1	3.2	52.8*	55.1*	56.6*
Ireland	No (9/94)	2.3*	1.5*	1.1*	84.8	80.2	76.0

Italy	Yes (9/94)	7.1	6.7	3.7	124.9	124.4	122.9
Luxembourg	No (9/94)	-0.4*	-2.0*	...*	6.1*	...*	...*
Netherlands	Yes (9/94)**	4.0	2.6*	2.3*	80.0	78.0	76.0
Austria	Yes (7/95)	5.9	4.3	3.0*	69.0	71.8	73.3
Portugal	Yes (9/94)	4.9	3.8	2.9*	71.7	70.3	67.6
Finland	Yes (7/95)**	5.4	2.9*	1.7*	59.2*	60.1	60.2
Sweden	Yes (7/95)	7.9	3.8	2.5*	79.4	78.7	78.5
U.K.	Yes (9/94)	5.7	4.8	3.7	53.9*	56.1*	56.5*

*** Equal to or less than reference values stipulated in Protocol 5 (3 % for the deficit and 60 % for public debt).**

**** As the paper went to press in May 1997, the Council decided that the Netherlands and Finland no longer had "excessive deficits".**

Source: 1995 data and estimates for 1996 and 1997 reported in OECD 1996, pp. 9, A33, A69. The negative signs for Luxembourg for the deficit indicate a budget surplus.

Table 3

Growth and Unemployment in the European Union, 1995-97

	% Change in "Real GDP"			% Unemployed (Commonly-used measures)		
	1995	1996e	1997e	1995	1996e	1997e
Belgium	1.9	1.3	2.2	13.0	13.2	13.0
Denmark	2.8	1.9	2.9	10.3	8.9	8.6
Germany	1.9	1.1	2.2	9.4	10.3	10.4
Greece	2.0	2.2	2.5	10.0	10.1	10.3
Spain	2.8	2.1	2.7	23.3	22.7	22.4
France	2.2	1.3	2.5	11.7	12.4	12.5
Ireland	10.3	7.0	6.2	12.2	12.0	11.8

Italy	3.0	0.8	1.2	12.0	12.2	12.2
Luxembourg	3.7	2.4	3.1	3.0	3.1	3.0
Netherlands	2.1	2.7	2.7	7.1	6.6	6.2
Austria	1.8	1.1	1.4	5.9	6.2	6.5
Portugal	2.4	2.6	2.9	7.2	7.2	7.1
Finland	4.2	2.5	3.5	17.2	16.4	15.5
Sweden	3.6	1.7	2.2	7.7	7.9	7.4
U.K.	2.4	2.4	3.3	8.2	7.6	7.4
EU	2.5	1.6	2.4	11.2	11.4	11.3

Source: OECD 1996, pp. A4, A24.

Table 4

Support for the European Community: Percent Believing Country Has Benefited/Not Benefited/Not Benefited from Membership?

	November-December 1995			
	Percent Saying Membership			Change in Net Percent Saying
	Has Benefited Country	Has Not Benefited Country	Net	Membership Has/Has Not Benefited Country October-November 1991 to November-December 1995
Ireland	80	7	73	+6
Greece	72	18	54	-5
Luxembourg	66	19	47	-10
Netherlands	66	20	46	-16
Portugal	66	21	45	-28

Denmark	59	29	30	-12
Italy	52	22	30	-14
Belgium	45	35	10	-38
Germany	40	36	4	-18
U.K.	40	43	-3	-10
France	39	39	0	-22
Spain	39	41	-2	-31
Finland	39	42	-3	N/A
Austria	32	47	-15	N/A
Sweden	19	54	-35	N/A
EU	44	35	9	

Full wording: "Taking everything into consideration, would you say that [our country] has on balance benefited or not from being a member of the European Union?"

Source: *European Commission 1994,* pp. 89-97; 1996, p. 17.

Table 5

Public Support in the EU for Introduction of a Single Currency, October-December 1995

	% Favoring/Opposed to Introduction of Single European Currency*		
	Yes	No	Net
Italy	68	10	58
Netherlands	64	28	36

Ireland	60	17	43
Luxembourg	59	22	37
Spain	58	18	40
France	58	23	35
Greece	52	20	32
Belgium	51	25	26
Portugal	46	21	25
Germany	34	45	-11
Finland	33	53	-20
United Kingdom	32	56	-24
Denmark	32	60	-28
Sweden	29	54	-25
Austria	23	43	-20
EU	47	33	14

Full wording: "Are you for or against the European Union having one European currency in all member states, including (respondent's country)? That is, replacing the (name of currency) by the European currency? Are you very much for, somewhat for, somewhat against, very much against, neither for nor against, or don't know?"

Source: ***European Commission 1996,*** **p. 49.**