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## Challenges on the Way to Stage Three of European Monetary Union

*While the Maastricht Treaty envisages a single European currency as part of the Economic and Monetary Union, it contains no detailed instructions as to the practical arrangements for its introduction. Despite prolonged discussions and negotiations at various levels, no consensus has so far been achieved on the optimum changeover procedure. This article deals with some of the major challenges in this context.*

The Madrid Summit of the European Union in winter 1995 will be decisive for the transition to a single European currency. The course towards this was set under the French EU presidency this June.

Under pressure from the European Parliament, the European Commission presented a scenario for the introduction of a single currency, since political commitment to the project appeared to be missing, although the European Monetary Institute (EMI) was in the process of its preparation. This gave new impetus to this ambitious project, which is without precedence in history. The European Commission and the EMI have to come forward by the end of September with proposals to be dealt with by the Finance Ministers of the European Union. The European Parliament will vote on its position in the October plenary session.

What is the problem? The convergence criteria laid down in the Maastricht Treaty will have to be met, but at present apparently only Luxemburg and Germany fulfil the nominal convergence criteria. The convergence programmes of all the Member States therefore envisage stronger measures to fight their budget deficits, which would seem to be extremely difficult at a time when mass unemployment is the key problem in all Member States. Nevertheless, the Monetary Union has to be prepared in a credible and acceptable way. The European Commission's Green Book on the transition to a single currency invites reflection, discussion and decisions on the scenario, the legal framework and policies concerning target groups such as, for example, banks and their customers,

industry, small and medium-sized entrepreneurs, tourism and, of course, consumers. The ideal model for the transition would be the Big Bang scenario but this is unfeasible for technical reasons. Other models have to be examined.

The Commission supports a critical mass scenario, which foresees monetary policy in ECU; exchange policy in ECU; interbank, capital, monetary and exchange market operations in ECU; loans issued in ECU; and the payment system in ECU. All of this would underline the irreversibility of the entire exercise after the conversion rates had been fixed irrevocably and the European Central Bank had begun its work. The debate is about the phases of the transition process and about the time needed for the various stages within Phase Three. The most important thing is that the model chosen is credible, that it is acceptable to the different target groups, to the population as a whole and to the markets, and that it helps to limit speculation. The model will also have to take the costs of transition into consideration.

The examination of the degree of convergence is therefore of primary importance. The first convergence report will be presented by the EMI in autumn 1995. The first official examination will take place in 1996 and if the majority of the EU Member Countries do not fulfil the convergence criteria at that time the exercise will have to be repeated in 1998.

On the basis of these reports from the EMI and the Commission the Council of Ministers, acting by a qualified majority on a recommendation from the Commission, shall assess for each Member State whether it fulfils the necessary conditions for the

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adoption of a single currency and recommend its findings to the Council of the Heads of State or Government. The European Parliament shall be consulted and forward its opinion also to the European Council. This consultation right of the European Parliament is extremely important. It will ensure that the whole decision process will not be shrouded in secrecy. Parliament's participation will guarantee a minimum of transparency and democratic accountability. The directly elected European Parliament represents, after all, the European electorate.

Taking due account of the aforementioned reports and the opinion of the European Parliament, the European Council shall, acting by a qualified majority, no later than December 1996 decide, on the basis of the recommendations of the Council of Ministers, whether a majority of the Member States fulfil the necessary conditions for the adoption of a single currency and decide whether it is appropriate for the Community to enter the third stage, and if so, set the beginning of this stage. If, by the end of 1997, the date for the beginning of the third stage has not been set, the third stage shall start on 1 January 1999 with the Member Countries fulfilling the necessary conditions for the adoption of the single currency. Keeping this time schedule in mind, it might be useful to check what still remains to be done with a view to convergence and preparatory work.

## **Institutional and Conceptual Challenges**

The changeover to Monetary Union requires new institutional solutions for steering the single European currency, as well as new strategical and operational concepts for the execution of the European monetary policy. Whereas the Treaty contains a relatively clearcut structure for the institutional part, namely for the European System of Central Banks (ESCB) and its primary objective of maintaining price stability, instructions on the way to achieve this goal are less detailed. The Treaty nevertheless gives a clear orientation by its adherence to fundamental principles like

- ☐ an open market with free competition,
- ☐ subsidiarity and decentralisation, and
- ☐ price stability as a primary objective of monetary policy.

All preparatory work for Stage Three, e.g. in the fields of monetary policy, foreign exchange policy, statistics, payment systems, and issuance of bank-

notes must be guided by these principles. Without claiming completeness, the subsequent part of the text shall deal with some of the major challenges in this context.

## **Introduction of the Single Currency**

At the starting date of the third stage, the Council shall – acting with the unanimity of the Member States without derogation on a proposal from the Commission and after consulting the ECB – adopt the conversion rates at which their currencies shall be irrevocably fixed and at which irrevocably fixed rate the ECU shall be substituted for these currencies. The ECU will become a currency in its own right. This measure shall not by itself modify the external value of the ECU. The Council shall, acting according to the same procedure, also take all other measures necessary for the rapid introduction of the ECU as the single currency of those Member States.

Despite the brief content of the Treaty on the introduction of the single currency, this issue is one of the most important and sensitive ones, not least because it will be decisive for the initial contact of the population with the new currency. Much conceptional work on the introduction of the single European currency has already been carried out by the European Parliament, by the EU central banks, by the EMI as well as by the Cees-Maas-Group and the European Commission. Indeed the Commission has outlined a concrete proposal on this issue: the Green Paper. The principal approach of the Commission can be welcomed. Scenarios for the introduction of the European currency have to be assessed mainly on the basis of the following criteria: rise in acceptance, feasibility, compliance with the legal framework and credibility of the process, simplicity, flexibility and low costs. The proposals of the ECOFIN at the informal meeting in Versailles in April 1995 are similar to the scenario for transition which was presented by the Commission on 31 May 1995 in the Green Paper "On the practical arrangements for the introduction of the single currency" (COM(95) 333 final). Nevertheless the Cees-Maas-Group suggests a faster period of transition; so does the European Parliament.

It ought to be kept in mind that all existing contributions for scenarios on the introduction of the single currency have to be regarded as preliminary. In the EU there is no consensus yet on the optimum changeover procedure. Especially in the European Monetary Institute, in its Sub-Committees and Working Groups as well as in the EMI-Council the discussion is still ongoing. Moreover negotiations are being held on the national level between

governments, central banks, private sector banks, administrations and lobby groups.

Nevertheless, there seems to be no doubt that the way to the single currency will be a way of three phases. Phase A will range from the decision on the introduction of the currency until the beginning of Stage Three. In this phase the ECB will be set up and the necessary organisational and technical measures will be taken in order to achieve operability. A time horizon of one year for phase A, as proposed by EMI President Lamfalussy and by the Commission, would be realistic.

One of the top priorities in phase A will be the appointment of the President, the Vice-President and other members of the Executive Board of the European Central Bank. This lies in the responsibility of the European Council which shall act on recommendation from the Council and after consulting the European Parliament and the Council of the EMI. Since decisions in the ESCB cannot be made until after this has been accomplished, it ought to be done as quickly and efficiently as possible, in order to guarantee the full use of the time period foreseen for phase A for substantial preparatory works. The Monetary Sub-Committee of the European Parliament has underlined how sensible the setting-up procedure for a new institution like the EMI or the ECB is, and that the initial work can be hampered unnecessarily by a late appointment.

During phase A the ECB has to hire all the personnel needed, and it can rely only partially on the EMI staff since their contracts end with the work of the Institute. Furthermore the EMI has no competences in the field of monetary-policy making. Therefore all related technical and personnel support has to be built up by the ECB itself.

The importance of the strict observance of the convergence criteria is highlighted once more, in view of possible speculative attacks against national currencies during phase A. It cannot be precluded that markets might be tempted to take undue advantage of the fact that the freezing of the announced EMU-members lies ahead at a fixed date. Although the EMI has announced plans for appropriate countermeasures it should be clear that there will be no target for speculation only if the group entering into Monetary Union is sufficiently and lastingly homogeneous with regard to price stability policies. This is also important in order to minimize the danger of capital flight from the currencies of EMU-aspirants to reserve currencies like the US-Dollar or

the Yen. It would be useful, in this context, to ensure that the control of fiscal policies in Stage Three of EMU will be solid and in line with the EMU's primary objective of price stability.

Phase B will start at the beginning of Stage Three and end with the introduction of coins and bank notes in phase C. On the first day of phase B the rates of exchange of the participating currencies will be irrevocably set. It ought to be kept in mind that only the European Central Bank should conduct monetary policy in the single currency from that day on. Despite the complex technical work to be carried out for the final introduction of the single currency, European Monetary Union will start already at the beginning of Stage Three (or phase B in the Commission wording). This is the decisive monetary and political step, which must not be forgotten in order to give the right priorities to the necessary preparatory measures.

According to the Maastricht-Treaty (Article 109 I (4)) the Council shall take the measures necessary for the rapid introduction of the ECU as the single currency of the EMU-Member States. Therefore the European Parliament very rightly states in its May-Plenary-Resolution that, in accordance with the Treaty, the period from the start of European Monetary Union to the introduction of the ECU should be as short as possible. Therefore the delay of three years for the complete introduction of the ECU proposed by the Commission and the EMI is not only contrary to the Treaty but also disastrous for the credibility of the whole of the EMU project as well as dangerous for the financial market which must be convinced that the participating currencies have been locked together irrevocably.

Phase B is necessary since the preparation and production of banknotes is a time-consuming matter. Moreover, cash registers, ticket machines and vending machines have to be prepared. This replacement operation needs to be meticulously prepared. Nevertheless, if an early decision on the notes and coins is taken immediately after the installation of the ECB, phase B can be fairly compressed. Phase B can be shortened especially if the preparatory work starts now. Industry and a part of the banking sector share the opinion of the European Parliament that three years are too long, cost too much and will not contribute to the credibility of the EMU. This seems to be appropriate because phase B will cover a critical period in which national banknotes and coins will still be circulating, although some transactions will already be executed in the single European currency. Insofar transaction costs might increase during a brief period.

Phase B as well as phase A and the years to come will serve as an educational period where pricing in the national currencies as well as in the single European currency should facilitate the changeover for the European citizens. The Commission is correct in placing so much weight on the necessity to inform the population about the changeover and persuade them of the advantages of the single currency as the European Parliament has demanded for a long time. On the other hand risks involved with abandoning the exchange rate instrument must not be concealed and be presented together with solutions. The European Parliament is currently preparing to launch a comprehensive joint information campaign with the European Commission, to be conducted in all the Member States.

The question as to which transactions shall be executed in national currency and which ones in the single currency during phase B, has to be addressed principally under the aspects of efficiency (costs) and stability. Although it is clear that the most important conditions for the stability of the changeover process are the homogeneity of the Monetary Union and the strict adherence to the convergence criteria, some irrational market behaviour might lead to turmoil and a flight into hard EU currencies in phase B. Therefore a critical mass of transactions, i.e. transactions between the ESCB and the central banks, between the ESCB and the private banks as well as all transactions between the Monetary Union and countries outside and interbank transactions should be denominated in the single European currency so that in value terms 90% of all transactions will be expressed in ECU from Day One. It must not be forgotten that a parallel use of currencies is very costly for all parties involved and that its volume should therefore be kept as small as possible.

After all several legal problems have to be solved with respect to the introduction of the single currency such as the relation between the ECU and national denominations in phase B, the questions of legal tender, continuity of contracts, rules for rounding and legal issues relating to bank notes. The European Parliament has pointed to the need to clarify the situation as quickly as possible in view of ECU clauses in contracts and similar questions of liability, the effects on companies' accounting and control procedures, the role of public administration, the practical impact on consumers.

Phase C will last as long as necessary to complete the physical replacement of national notes and coins. It would mark the completion of the introduction of the single currency and involve the following steps: the

exchange of notes and coins, the single currency's becoming legal tender, the completion of the changeover of the banks and the financial system (all means of payment are converted into the single currency), in conjunction with the domestic settlement systems, and the private non-bank sector's conducting all transactions exclusively in the single currency. The old national currencies may be exchanged free of charge at the national central banks during the statutory period laid down in each country.

### **Monetary Policy Strategy**

Besides the organisational foundation, the existence of a common monetary policy concept is another necessary precondition for the commencement of Stage Three. The policy must be decided centrally by the Council of the European Central Bank (ECB) for the whole of the monetary union, but can and should be executed as far as possible in a decentralized approach by the central banks which are members of the ESCB.

It is, of course, the EMI that has the responsibility for preparing the monetary policy framework and the necessary instruments for the ECB. Not touching this competence, the European Parliament has contributed to the discussion on the suitable concept for monetary policy in the third stage. In a resolution of 6 May 1994 it expressed the view that a publication of one or several intermediate monetary targets by the ECB would not only be in accordance with the principles of transparency and accountability, but would be of fundamental importance to attain the final aim of price stability. Of course there must be a stable relationship between the intermediate targets and the final target, and the ECB needs to be able to control the intermediate target. The European Parliament is aware of the fact that it is impossible to render a final judgement on the optimal strategy because of various uncertainties at the beginning of the third stage: about the set of participating countries; because of the possible change of the existing current relations between monetary aggregates and the price goal; because of the growing economic integration in the market and further financial innovation; as well as because possible exchange rate arrangements between the monetary union and other countries are unknown.

Despite such uncertainties there are several arguments in favour of an ECB-monetary policy target involving a monetary aggregate or some other indicator: The announcement of a target strengthens the independence of the ECB, especially in the case of policy-mix conflicts and contributes to the

accountability of the ECB and the transparency of monetary policy decisions. At the beginning of the third stage the ECB will have no reputation of its own. It must therefore strive to establish its own credibility. This seems to be inconsistent with a pragmatic approach based solely on its independence and the final objective. Credibility would lead to enhanced effectiveness of monetary policy. It could be further strengthened if the ECB were to commit itself to a rule by which "its hands are tied", which excludes uncertainty created by discretionary measures decided upon in response to sudden events. The medium-term orientation of monetary policy would be even more credible from the viewpoint of the public if the need for frequent adaptations of the ECB's target is avoided; such a medium-term orientation could give the ECB some leeway to tolerate deviations from a target in the short run.

### **Monetary Policy Instruments**

The next question is how to implement the common monetary policy. There can be no question that the monetary policy for the monetary union in the third stage must be centrally decided. The Statutes of the ECB clearly indicate that the ECB-Council shall determine that policy. But implementation of monetary policy could be as decentralized as possible with the help of the national central banks. They should be entrusted with implementing the monetary policy decisions of the ECB, according to the principle of subsidiarity. The monetary policy instruments of the ESCB must be developed in such a way as to permit this. While the ESCB Statutes do not elaborate on instruments, there is a strong argument for open market interventions, since they comply with the principle of a free market. The ECB should therefore carry out open-market policies.

One instrument foreseen by the Statutes of the ECB does not comply with market principles: required minimum reserves. Still, this instrument would be particularly suitable for a decentralized implementation of monetary policy because it would stabilise the demand for money, thereby diminishing the need for interventions of the ESCB in the money markets. Such required minimum reserves could be held by banks with their national central bank. Moreover, minimum reserves and standing facilities like a rediscount or lombard line can contribute to the stabilisation of short-term market interest rates. As a result, central banks would have to intervene less frequently in the money market.

Viewing the difficulty and importance of the task of applying monetary policy in a new and European

scale framework, the European Parliament has proposed a trial phase at the end of Stage Two. On a voluntary, reversible basis those central banks liable to participate in the third stage could already test the monetary policy strategy for the third stage. Potential systemic errors could then still be corrected without severe consequences. Such a phase would also be useful to show the determination of the participating Member States to stick to the stability goals enshrined in the Treaty.

The single monetary policy in Stage Three cannot function properly without an efficient payment system. Otherwise there would be no homogeneous money market in the single currency. The present transborder payments system within the European Union is clearly inefficient and too costly. According to a study carried out by the European Commission, on average a cross-border transfer of 100 ECU costs 25 ECU and takes more than 5 working days. The new directive very rightly, according to the proposal of the European Parliament, stipulates that cross-border transfers should not exceed a maximum time of 5 days, that there should be more transparency of the costs and conditions of the transfers and that the banks have to be made liable for amounts which are lost during the transfers. This directive only refers to payments of less than 50,000 ECU since big companies already have special arrangements with their banks for cross-border transfers.

The EMI and the EU central banks have focused on large-value payments, which are of the greatest importance for the creation of the money market in the European currency. They are planning an EMU-wide real-time gross settlement (RTGS) system in each country and a system interlinking all RTGSs in order to process cross-border payments.

### **Challenges for Economic Policy**

It is well understood that a monetary union consisting of member countries which are too heterogeneous in their economic structure and with regard to their preferences for price stability, cannot work. Therefore the Maastricht Treaty establishes a set of minimum conditions which shall ensure that Member States undergo a respective adjustment process already before entry into Stage Three. Their efforts will be measured most notably by four main convergence criteria aiming at price stability, sound public finances, stable exchange rates, and low long-term interest rates with disappearing differentials.

It goes without saying that the convergence criteria have to be strictly applied. Any other attitude would

not only reveal a lack of European commitment but also a lack of insight in the potential risks of a heterogeneous monetary union.

The EMI will publish its first convergence report (with respect to Article 7 of its Statute) in the autumn, but the Institute has already provisionally explained in its Annual Report that the Union has made notable progress towards price stability and that convergence also increased in some other areas during the last years. The EMI states on the other hand that decisive deficiencies remain: several countries still record unsatisfactory levels of inflation rates, and convergence is not established firmly enough to discourage challenges to policy from developments on foreign exchange and bond markets. The largest single problem continues to be the worrisome state of the fiscal positions of most EU countries. Therefore the Member States must commit themselves to more effort and use the momentum created by the current economic upswing, especially to reduce their public debt.

#### **No Split between EU Members**

Member States which do not participate in Stage Three immediately can join at any time as soon as they fulfil the criteria. At least once every two years, or at the request of such a Member State, the Commission and the European Central Bank shall report to the Council of Ministers in accordance with the procedures laid down in Article 109j of the Treaty for the assessment of a possible entry of the European Union into Stage Three.

Furthermore, the validity of the argument that the variable speed approach of the Treaty might prevent the "Member States with a derogation" (i.e. the states which do not join immediately) from catching up can be doubted. On the contrary: a necessary and sufficient condition for economic growth is the accumulation of capital, from foreign or own sources. Participation in Stage Three is therefore by no means necessary for increasing the economic strength of a country. Entry into Stage Three, at too early a time, might even threaten the catching-up process, for it would put the economy in question under the regime of the Single European Monetary policy which cannot differentiate between European regions in different economic conditions.

However it must be made clear that there will be no split between the EU members within Monetary Union and those who have not yet entered, and that the latter will get all appropriate support for joining as soon as possible. A primary measure should be to

bind their currencies and the single European currency in an exchange rate system similar to the EMS. Such a step would not only bring about economical but also political benefits. The European Parliament has called for respective plans in May 1995.

#### **The Intergovernmental Conference of 1996**

The Intergovernmental Conference for the revision of the Maastricht Treaty shall be convened in 1996 to examine those provisions of this treaty for which revision is provided (Art. N, 2nd paragraph of the Treaty on European Union). A reflection group has already begun with the preparations for this conference. The rather narrow scope of the intergovernmental conference will have to be enlarged to tackle a wide range of institutional questions, the most important ones being progress towards a political union worthy of that name and decisions on the institutional framework for a European Union of perhaps double the present number of Member States or even more.

The question remains, whether it would be possible for a monetary union to function without a parallel political union. The current picture is very asymmetric. The Maastricht Treaty provides for an almost totally centralized monetary union in the third stage. As a means to an end, monetary union has been thought of as a catalyst for the process towards deeper political as well as economic integration. A currency union in Europe without some form of political union would indeed be a historical first, at least on this scale. Full political union alongside economic and monetary union would, of course, pose important questions. Economic and fiscal policies are still national policies which might be coordinated but only on a voluntary level. Obligatory rules for coordination and cooperation in this field should therefore be considered for the longer term, in view of deep concerns about the imbalance between Economic and Monetary Union. Moreover, the ECB in the third stage requires a counterpart that is able to support a stability-oriented monetary policy. The present system relies on the European Council's issuing of Broad Guidelines that form the basis for multilateral surveillance in the asymmetric Council. The European Parliament criticizes the fact that Broad Guidelines are not legally binding, neither in the present second nor in the third stage. Everything is open to voluntary cooperation. Therefore a new economic authority acting as a counterpart to the powerful European Central Bank will be needed as demanded by the European Parliament in the third stage.