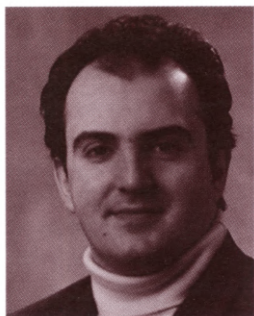


# The coming of the Euro

by Christopher Bovis



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Christopher Bovis examines some of the convergence criteria set down by the Maastricht Treaty in the run-up to full monetary integration.

The idea of monetary integration as an integral part of the evolution of the common market process was conceived after the elapse of the first transitional period of the European Communities (December 1969), when the founding six member states declared their aim to form an economic and monetary union. The development of the framework of economic and monetary union was dominated by two schools of thought: the *monetarists* (those who argued for keeping the exchange rates of the currencies involved in narrow bands, a situation which could be reinforced by mutual credit assistance and the amalgamation of foreign reserves) and the *economists* (those who advocated that the co-ordination of macro-economic policies at centralised level should come first, before any control of exchange rates was introduced). In order to create a monetary union within the common market, volumes of national budgets and methods of financing deficits had to be co-ordinated, tax rates had to be mutually adjusted and an indicative planning of economic growth had to be introduced. Apparently, the economic and monetary elements in the exercise were closely interrelated.

## IMPACT ON INTEGRATION

The Single Market programme has been having a significant impact on economic integration, particularly on the structure of trade between member states, foreign direct investment flows, competition conditions and price convergence for certain categories of goods and services.

Initially, the limited availability of instruments of economic and monetary co-operation amongst the member states of the European Community, as well as the collapse of the international monetary system in 1971, resulted in high inflation and a considerable decrease in growth rates and reinforced the need for a centralised control system of economic stability. Such a system would satisfy economic growth patterns which could sustain high employment levels. The establishment of the European Monetary System (EMS) helped member states to control inflation and stabilise exchange rates. The first step towards a centralised control system of economic policy was achieved by the creation of the ECU (European Currency Unit), as a weighted cascade of European currencies and the Exchange Rate Mechanism (ERM), a system where margins of currency fluctuation were set at maximum and minimum levels. The

creation of the EMS, however, only achieved exchange rates co-ordination amongst the member states. A common exchange rates policy could only influence interest rates; monetary and budgetary policies were still in the hands of the national governments.

The conclusion and ratification of the Maastricht Treaty on European Union by the member states has accelerated the process of the completion of monetary integration in the common market, in as much as the Treaty on European Union introduced a comprehensive framework and plan of action concerning the European Monetary Union (EMU). The Maastricht Treaty, inter alia, conceptualised the member states' obligation to establish a common economic and budgetary policy, which are prerequisites for monetary union.

## THE INSTITUTIONAL STRUCTURE OF THE EMU

The objective of the European Community to establish a genuinely common market legally empowers its member states to adopt a common economic policy which is based on the close co-ordination of their domestic economic policies, conducted in accordance with the principles of open market economy and free competition. A major part of such co-ordination should include the irrevocable fixing of exchange rates which would then lead to the introduction of a single currency within the definition and conduct of a common monetary policy. The establishment of a common economic and monetary policy at centralised level, should entail price stability within the common market, sound public finances and a sustainable balance of payments. For the purposes of embarking upon the creation of economic and monetary union, the Maastricht Treaty envisaged the establishment of a number of influential institutions, alongside the European Commission, the Council of Ministers and the European Parliament. These institutions include the European System of Central Banks (ESCB) and the European Central Bank (ECB) and the European Monetary Institute (EMI).

The main objective of the ESCB is to maintain price stability within the common market. The ESCB is composed of the European Central Bank and of the central banks of the member states. Its tasks include:

- the definition and implementation of the monetary policy of the European Community;
- the conduct of foreign exchange operations;

- the holding and management of official foreign reserves of the member states; and
- the promotion of smooth operation of payment systems amongst member states.

The European Central Bank is the watchdog of the European System of Central Banks. Its main responsibility is to ensure the implementation of the tasks and duties conferred upon the ESCB by the Maastricht Treaty. The European Central Bank is the institution responsible for the formulation of the monetary policy of the Community, including decisions relating to intermediate monetary objectives, key interest rates and the supply of reserves in the ESCB. The ECB may also operate in financial markets and conduct credit operations with credit institutions and other market participants.

The European Monetary Institute has taken over the activities and portfolio of the European Monetary Co-operation Fund and among the EMI's primary objectives are the consultation of national central banks and the strengthening of their co-operation, the monitoring of the functioning of the EMS and the development of an effective clearing system.

The Maastricht Treaty stipulates that the following convergence criteria must be met by the member states in order to qualify for the EMU. These criteria include:

- the inflation rates must not exceed 1.5% above the average of the three lowest inflation rates (inflation is measured by reference to harmonised indices of consumer prices (HICP));
- the general government deficit must not exceed 3% of the Gross National Product, other than in exceptional circumstances;
- the general government debt must not exceed 60% of the Gross National Product, with the exception of countries showing steady progress towards the above target;
- the long-term interest rates must not exceed by more than 2% the rates of the lowest-inflation member state;
- the exchange rates must be kept within the narrow bands of the European Monetary System which is 2.25%.

The institutional framework of the European Monetary Union established by the Maastricht Treaty is based upon the assumption that central banking institutions at both community and national levels remain independent from governmental influence.

**on the internet**

<http://europa.eu/int/euro/htm/home5.html?lang=5>

The official EU site about the Euro provides a wealth of interesting information including statistical data, a countdown timetable, publications and links to other useful sites.

**ASSESSING AND MONITORING PERFORMANCES**

Article 109j of the Maastricht Treaty requires the Commission to report to the Council on the progress made in the fulfilment by the member states of their obligations regarding the achievement of convergence criteria for the economic and monetary union. A similar report is required by the EMI. These reports represent the procedural stage for the adoption of legislative measures by the Council in relation to which member states fulfil the necessary conditions for the adoption of a single currency. The Commission presented a report in 1996 which

was followed by a Council decision. At that time, a majority of the member states did not fulfil the necessary conditions for the adoption of a single currency and, as a consequence, the starting date for the third stage of EMU was set for 1 January 1999. Although two member states (Denmark and the UK) have already exercised their opt-out rights in accordance with Protocol No. 12 to the Maastricht Treaty, the convergence performance of these two countries has been examined by European institutions along with the other member states. On the basis of the current technical information available to the European institutions (the Commission and the European Monetary Institute) and the reports on the convergence progress of the member states, the Commission has submitted to the Council of Finance Ministers ('Ecofin') a recommendation for the assessment of each member state whether it fulfils the necessary conditions for the adoption of a single currency. Ecofin will then recommend its findings to the European Council (the Council in the composition of Heads of State or government), which will expound a formal, legally binding, decision.

**TREATY INSTITUTIONS**

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**COMPATIBILITY OF LEGISLATION AND CONVERGENCE**

Since the beginning of the second stage of the EMU (1 January 1994), member states have achieved a high degree of sustainable convergence. This progress gathered momentum during 1996 and 1997, when efforts to meet the convergence criteria (especially in the budgetary field) were intensified in many member states. Other necessary preparatory conditions for the third stage of the monetary union have also advanced at both national and Community levels. Compatibility between national legislation, in particular the legal frameworks of national central banks, and art. 107 and 108 of the Maastricht Treaty and the Statute of the European System of Central Banks, is of paramount importance as a convergence requirement. Compatibility has to be ensured in relation to the objectives of national central banks and their independence and in respect of provisions affecting the integration of the national central banks in the ESCB. (Member states are required to ensure the compatibility of their legislation by the date of the establishment of the European Central Bank.)

Most member states have already enacted necessary changes in legislation, or are in the process of legislating on government proposals for changes. The situation in eight member states (Belgium, Germany, Greece, Ireland, Italy, the Netherlands, Portugal and Finland) can be considered as compatible with treaty requirements, while in four member states, compatibility will be ensured provided that the existing government proposals are enacted (in Spain, Luxembourg and Austria) or the present draft government proposal is submitted to, and adopted by, Parliament (France). In the case of Sweden, the requirements of



their constitution will prevent adoption of the government's proposals before late 1998, and there remain some incompatibilities between the present draft laws and the Maastricht Treaty. By virtue of their opt-outs, Denmark and the UK are under no obligation to make their legislation compatible, except for the independence of their central banks. In the case of Denmark, the relevant legislation is compatible.

## THE ECONOMIC PERFORMANCE INDICATORS

The high degree of sustainable convergence achieved by the member states in fulfilling each of the convergence criteria of art. 109j(1), concerning price stability, the government budgetary position, exchange rates and long-term interest rates is analysed below.

### *Price stability*

The steady progress made in the community as a whole and by individual member states in moving towards or maintaining a high degree of price stability continued in 1997 and 1998. The assessment of price stability and inflation convergence in the member states has been made using the recently available harmonised indices of consumer prices, which provide a better and more comparable basis for the assessment than national consumer price indices do. The average rate of inflation for each member state has been calculated as the percentage change in the average HICP in the latest 12 months relative to the average index in the preceding 12 months. The reference value has been calculated as the average inflation rates in the three best-performing member states plus 1.5%. Calculated in this way and according to the latest available information (January 1998), the three best inflation performers were France, Ireland and Austria, and the inflation rate reference value was 2.7%. Fourteen member states (Belgium, Denmark, Germany, Spain, France; Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal, Finland, Sweden and the UK) had average inflation rates below this reference value. In view of the structural changes (both institutional and behavioural) which have played an important role in achieving price stability and given the developments in unit labour costs and other price indices, there are strong reasons for believing that the current inflation performance in all 14 of these member states is sustainable. Greece has also had success in bringing the inflation rate down but it still remains much higher than the reference value.

### *Government budgetary positions*

The assessment of the convergence criterion on the government budgetary position is linked to decisions made in accordance with the excessive deficit procedure in art. 104c of the Maastricht Treaty. At present five member states (Denmark, Ireland, Luxembourg, the Netherlands and Finland) do not have excessive government deficits and so already fulfil the criterion. Government deficits have generally been brought down significantly during the second stage of EMU from the levels reached in 1993, when they were swollen by the effects of the recession throughout Europe. Further substantial progress was made by member states in 1997. In 1997 the deficits in 14 member states were either below or equal to the 3% of gross domestic product (GDP) reference value, and further declines in deficits are expected in 1998. While the government debt ratio

was below the 60% of GDP reference value in 1997 in only four member states (France, Luxembourg, Finland and the UK), almost all the other member states with higher debt ratios have succeeded in reversing the earlier upward trend. Only in Germany, where the debt ratio is just above 60% of GDP and the exceptional costs of unification continue to bear heavily, was there a further small rise in the debt ratio in 1997. In the current year (1998) falls in the debt ratio are expected in all the member states where the ratio is above the reference value. Conditions are also in place for a sustained decline in debt ratios in the coming years. The Commission is recommending to the Council the abrogation of the excessive deficit decisions for Belgium, Germany, Spain, France, Italy, Austria, Portugal, Sweden and the UK. While Greece has made substantial progress in reducing public finance imbalances in recent years, its deficit in 1997 was still well above the reference value but is expected to be below it in 1998.



### *The exchange rate criterion*

The Maastricht Treaty refers to the exchange rate criterion as the observance of the normal fluctuation margins of the exchange rate mechanism of the European Monetary System, for at least two years, without severe tensions and without devaluing against the currency of any other member state. The operational framework in order to interpret the exchange rate criterion verifies participation in the ERM for at least two years and assesses exchange rate behaviour with respect to a 2.25% fluctuation range around each currency central rate against the median currency in the ERM grid. The two-year period under review is from March 1996 to February 1998. Ten currencies – the Belgian franc, the Danish crown, the German mark, the Spanish peseta, the French franc, the Irish pound, the Luxembourg franc, the Dutch guilder, the Austrian schilling and the Portuguese escudo – have been in the ERM for more than two years. The Finnish mark entered the ERM in October 1996, while the Italian lira re-entered the mechanism in November 1996. The ERM has been generally stable and the vast majority of participating currencies have been clustered close to their ERM central rates in the period under review. Among these currencies, only the Irish pound has deviated from its central rate against the median currency for an extended period of time; however, the deviation of the pound has been mostly above its central rate. The Irish pound was revalued by 3% against the other ERM currency in March 1998 after the close of the review period. All in all, these twelve currencies can be considered not to have experienced severe tensions in the two years under review. The Greek drachma, the Swedish crown and the pound sterling did not participate in the ERM during the review period. However, the Greek drachma entered the ERM in March 1998, after the close of the review period.

**The long-term interest rate criterion**


The fourth criterion concerns the durability of convergence as reflected in long-term interest rates. Long-term interest rates are forward-looking indicators which reflect the financial markets assessment of underlying economic conditions, including the sustainability of inflation performance and budgetary positions. Developments in bond markets during the last two years, as the third stage of EMU approaches, have resulted in a significant narrowing in interest rate differentials, especially for the previously higher-yielding countries. The assessment of the criterion is based on the interest rates on comparable 10-year benchmark bonds (not fully comparable for Greece), using an average rate over the last 12 months. The reference value has been calculated as the average of the long-term interest rates of the three best-performing member states, in terms of price stability, plus 2%. At the beginning of 1998 the reference value of the long-term interest rate criterion was 7.8%. Fourteen member states (Belgium, Denmark, Germany, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal, Finland; Sweden and the UK) had average long-term interest rates below the reference value. Greece has also experienced declining interest rates over recent years, but the level of the long-term interest rate still remains higher than the reference value.

**OTHER RELEVANT AREAS**

The Maastricht Treaty also requires that developments in several other areas relevant to economic integration and convergence should be examined in conjunction with the economic performance indicators. The Single Market programme has been having a significant impact on economic integration, particularly on the structure of trade between

member states, foreign direct investment flows, competition conditions and on price convergence for certain categories of goods and services. The current account of the balance of payments reflects the national saving and investment balance in each member state; the community as a whole and ten member states are estimated to have been in surplus in 1997. Additional indicators for unit labour costs, import prices and other prices confirm the picture of a satisfactory and soundly-based price performance in most member states.

**CONCLUDING REMARKS**

On the basis of the sustainable convergence achieved by the relevant member states, the European Commission has recommended to the Council that Austria, Belgium, Germany, Finland, France, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain have met the necessary conditions for adopting a single currency (Euro). The accomplishment of the European Monetary Union and the arrival of the Euro have been long-awaited by European integration supporters as the necessary instruments to revitalise the European economy, sharpen its competitiveness, create jobs, foster investment and make the benefits of the common market more tangible for its consumers. The repercussions of the monetary integration will be greatly felt within the common market, but the Euro will make its impact predominately on international financial arenas, where it is expected to gradually become a leading transaction, investment and reserve currency. 

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