

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Seminar 96/3

11:20 a.m., March 6, 1996

M. Camdessus, Chairman  
S. Fischer, First Deputy Managing Director  
A. D. Ouattara, Deputy Managing Director

**Executive Directors**

M.-A. Autheman

I. Clark

H. Evans

E. R. Grilli

D. Kaeser

W. Kiekens

K. Lissakers

H. Mesaki

A. Mirakhor

S. Schoenberg

A. S. Shaalan

E. Srejber

**Alternate Executive Directors**

Al-Turki

O. Himani, Temporary

A. Fayolle

V. J. Fernández

C. X. O'Loughlin

D. Z. Guti

J. Shields

H. B. Disanayaka

N. Coumbis

L. M. Cheong

H. Mori, Temporary

H. A. Barro Chambrier

B. S. Newman

T. Fukuyama

J. A. Costa, Temporary

B. Esdar

Y. Y. Mohammed

B. Andersen

A. V. Mozhin

J.-H. Kang

O. Havrylyshyn

Han M.

L. Van Houtven, Secretary and Counsellor  
M. Cuc, Assistant

1. Progress Toward Economic and Monetary Union—Developments  
and Selected Issues ..... Page 3

**Also Present**

Central Asia Department: M. Quintyn. European I Department: M. Russo, Director; J. R. Artus, Deputy Director; M. C. Deppler, Deputy Director; E. V. Clifton, M. Fetherston, M. E. Hardy, G. R. Kincaid, R. Lamdany, T. D. Lane, A. Leipold, J. Levy, L. Lipschitz, D. C. McDonald, F. Scacciavillani, P. M. Thomsen. External Relations Department: P. M. Falcone, M. R. Hansen, L. Wallace. Fiscal Affairs Department: L. P. Ebril. S. A. Symansky. Legal Department: R. H. Munzberg, Deputy General Counsel; L. Nordgaard. Monetary and Exchange Affairs Department: J. H. Green. Office in Europe: J. K. Rosenblatt. Policy Development and Review Department: M. Allen, Deputy Director; G. O. Fratzscher, R. H. Nord, N. Tsaveas. Research Department: F. Caramazza, M. S. Kumar, F. Larsen. Secretary' Department: W. S. Tseng, Deputy Secretary; A. Mountford. Treasurer's Department: J. C. Corr, N. L. Wagner. Office of the Managing Director: J. Quick, Personal Assistant. Advisors to Executive Directors: J. M. Abbott, M. A. Ahmed, M. Alemán, P. Cailleteau, K. M. Heinonen, J. C. Martinez Oliva, R. von Kleist. Assistants to Executive Directors: S. Arifin, D. Daco, L. Fontaine, W. C. Keller, T.-M. Kudiwu, I. Moon, H. Paris, Y. Tahara, V. Trivedi, L. B. J. van Geest.

# **1. PROGRESS TOWARD ECONOMIC AND MONETARY UNION— DEVELOPMENTS AND SELECTED ISSUES**

The Executive Directors, meeting in a seminar, considered a staff paper on developments and selected issues relating to progress toward economic and monetary union in Europe (SM/96/41, 2/14/96; and Sup. 1, 2/22/96). They also had before them a statement by Mr. Giovanni Ravasio, Director General for Economic and Financial Affairs of the European Commission (see EBD/96/29, 3/4/96).

Mr. Shaalan made the following statement:

Undoubtedly, political momentum is propelling the movement toward monetary union. This being the case, unfortunately, it is safe to assume that if the progress toward a single currency falters, it could have serious ramifications for Europe. As the well-written staff report clearly pointed out, the dangers should not be underestimated.

Until recently, Germany was the only major country that met the qualifying budget criteria as set in the Maastricht Treaty; however, the growth in the budget deficit both in 1995 and possibly 1996 would leave Luxembourg as the only country that is in strict compliance with the reference values of the Treaty. Should the recessionary conditions that are emerging in a number of European countries become protracted, it is unlikely that the minimum threshold, of five to six countries, for an effective union would be met. On the other hand, in the context of high unemployment and the impact of what could be sizable adjustments required to attain the fiscal targets, social tensions could well emerge, adversely affecting support for the European Economic and Monetary Union (EMU). This is, therefore, a delicate area.

It must also be admitted that there are dangers to a slower path of adjustment. But I feel that in addition to the pitfalls of a fast-track adjustment, it may not be a sustainable path of adjustment. I would, therefore, strongly lean more toward a delay in the introduction of Stage 3. The risks associated with attempting to meet the present timetable, particularly in view of the fact that many important issues remain unresolved, could be high.

Two other points:

Yes, economic integration has been, as the staff says, a cornerstone for the rising prosperity in Europe. But is it correct to assume that a single currency is an essential complement to a single market for goods and services? I am not convinced. Neither am I altogether convinced by the argument that in the absence of monetary union, competitive depreciations may become a danger. Competitive depreciations were certainly not a problem in the two decades since the demise of the par value system, unless, of course, we have reason to believe that the globalization of financial markets in one way or another increased the risks of competitive depreciations. Staff views on these two issues would be appreciated.

Mr. Mirakhor made the following statement:

The staff has produced an interesting and timely paper. It provides a clear analysis of the policy issues and challenges that confront the EU as countries prepare for Stage 3 of EMU—challenges which, as the paper rightly notes, are being compounded by the recent slowing of growth in Europe and the threat that this poses to an orderly and smooth transition. Of course, the slowdown should not have been a surprise since over the past few years analysts have warned that deflation is a short-term risk as countries attempt to meet the convergence criteria, while struggling to keep inflation under control. But, economic weakness and growing unemployment only underline the historical fact that radical changes are not costless. Nonetheless, the strength of the resolve of the countries to move toward the Union will continue to be tested by the market. Indeed, the recent increased volatility in foreign exchange markets reflects uncertainties in various countries regarding the feasibility of achieving the Maastricht timetable.

Below are brief and selected comments on the main points in the paper as they relate to the role of economic policies, and the design and management of the EMU process before concluding with a few words on the role of the Fund.

On fiscal policy, the key question for countries with high deficits and large adjustment needs is the speed with which they can move to reduce their deficits and debt/GDP ratio to acceptable levels. The broad conclusion seems to be that credibility and confidence effects are crucial to attenuating short-term output costs and ensuring favorable medium-term growth and inflation performance. Indeed, the simulations show that the effects of early and rapid adjustment are benign as lower interest rate differentials feed into reduced government interest spending, and ultimately higher investment and growth.

The more difficult question posed is whether one can combine a slower pace of fiscal adjustment (which may be politically more acceptable) with a sufficient measure of credibility. This is the basis for the staff's two speed adjustment scenario (Annex IV) which suggests that the "costs" to the slow adjusters—in terms of a somewhat higher level of inflation and a postponement of the gains from fiscal consolidation—are not very large. The paper asserts that provided credibility can be acquired over a period of time (it is not clear how this might be done), a slow adjustment scenario for some countries is "nearly as satisfactory" as a fast adjustment track over the medium term. The question then is, if the difference between the fast and slow adjusters is not that large and does not lead to any unmanageable difficulties, why would countries want to take on the political risks that would normally accompany rapid fiscal adjustment in the first place. Is it possible that the scenario does not take sufficient account of convergence efforts that are accompanied—as indeed they must be—by structural measures? These could make important differences in price and output effects between countries—helping to attenuate short-term output costs and producing better wage and inflation performance, for example. In any event, fiscal consolidation cannot be realistically separated from the implementation of structural expenditure reforms, especially those aimed at improving labor market flexibility. The latter are essential

if budgetary cuts are to be realized and sustained, and if the political will to maintain strict financial policies is not to be called into question.

On exchange rate and monetary policy, as noted earlier, the recent tensions in exchange markets would appear to have their roots in fiscal and structural policy incompatibilities and growing political uncertainties over the commitment to EMU. The paper rightly stresses the role of confidence-building measures and the need for all countries to demonstrate their commitment to the success of the EMU in the way they work together. This raises the important related question on exchange rate arrangements, namely, whether there may be scope for some countries to use monetary policy to help offset the demand-dampening effects of fiscal tightening. Provided policy credibility is strong, fiscal adjustment alone can be expected to induce a reduction in interest rate premiums, and thereby provide support to the adjustment process; however, if markets are skeptical of the sustainability of the adjustment intentions of the authorities, attempts to exploit fluctuation margins could well carry significant risks.

On the important issue of whether monetary policy in Europe as a whole should provide support for economic activity, the recent easing of monetary policy conditions in a number of countries against the background of sluggish activity and favorable inflation prospects was, in our judgement, warranted and appropriate particularly given the "complementarity of needs" across the EU in favor of such action. Clearly, however, in some countries, care would have to be exercised to ensure that these adjustments do not cause markets to question the commitment to sound policies, including the appropriate and sustainable balance between external and domestic objectives, and between monetary and fiscal policies.

The staff paper makes a case for enhancing labor market flexibility generally citing it as a critical factor in determining whether a country is suitable for a monetary union. The persistence of high levels of unemployment, and structural rigidities in labor markets can exacerbate uncertainties, undermine the process of convergence in cost developments that are essential to stability in exchange markets, and contribute to market turbulence in the transition to monetary union and a single currency. Thus, there remains a compelling case for continued and reinforced action in the area of labor market reform.

The staff paper is pragmatic in cautioning against overestimating the speed with which reforms can produce improvements in labor market conditions and goes on to argue for appropriate measures, "timed and implemented in a manner that do not produce political and social disruption," but which can nevertheless boost confidence in the overall credibility of a government's policy strategy. While this is a sound advice, the question is whether a more gradualist approach will succeed in addressing the deep-seated nature of the labor market problems in EU countries and whether one should accept a dilution of the importance of proceeding forcefully with the implementation of labor market reforms.

There are several issues which pertain to the design and management of the EMU process. As one looks ahead, it appears more likely that trade-offs may need to be made between the timing of the Union and the number of participating states.

Of course, starting the Union with a large number of participants would be ideal and would maximize the benefits of the EMU process. However, the recent slowdown makes it likely that there may only be a few countries that will actually qualify despite growing pressures for a relaxation of the convergence criteria. To relax the criteria could risk sparking tensions in financial and exchange markets, and make the future stability of the Euro difficult. Moving ahead with a "core EU-5" seems to be the more likely outcome. This would help deepen the process of integration, but it could risk creating a rift between the 'northern' and 'southern' members of the EU.

It has been asserted that EMU is Europe's response to globalization in that it represents a long-term strategy. If so, then EMU must start; otherwise, European integration could suffer a severe setback. A delay of the start of Stage 3 beyond January 1, 1999 (which staff contemplates as a possibility) in order to enable more countries to qualify at a later stage would not only conflict with the Treaty but raise doubts about other Treaty provisions as well.

We support the call for an early agreement on the three institutional aspects raised in the staff report as being critical to building confidence in the EMU process and forestalling market tensions that may be triggered by uncertainties concerning the status of individual countries. Of these, an agreement on reinforced surveillance in Stage 3 would appear to be the most crucial; it would not only dispel the concerns of those who feel that the Treaty does not provide for sufficient discipline in Stage 3, but also offers scope for the exercise of judgmental factors in the convergence criteria, particularly with regard to the debt and exchange rate aspects.

Finally, a comment on the role of the Fund. There is no doubt that concerns about EU economic developments and prospects, and the risk of market tensions on the way to Stage 3 will present important challenges for Fund surveillance of EU countries. The Fund, through the exercise of its surveillance mandate, should maintain a close watch over the situation as it evolves with a view to discouraging potential market tensions, while also being in a position to address them in a timely and effective way, by bringing to the attention of the Executive Board the need for convincing and forceful policy adjustments. We endorse the proposed scope and format of future papers on EU issues but would welcome a greater focus on an analysis of the impact of the convergence process on individual countries outside the EU. The latter is of particular concern to my authorities. While the aggregate effect may be small, the impact of fiscal convergence and financial market sentiment on countries with strong economic ties to the EU could be substantial.

Let me conclude by posing a question to the staff. Generally, the financial institutions in Europe do not seem to have been taking an active positive stance on EMU, and one wonders why that should be so. Is it because they are not aware, or perhaps convinced, of the long-term benefits of the Union, or is it because not enough has been done to forge a real partnership between the political decision-makers and the financial sector in Europe toward creating a smooth transition to EMU?

The Director of the European I Department indicated that the simulations in the staff's paper on EMU reflected the assumptions from the new World Economic Outlook (WEO).

Structural measures designed to correct labor market rigidities would be essential to EMU sustainability, the Director continued. However, their positive impact during the transition toward EMU would probably be limited because such measures would take time to implement and their effects would materialize over a longer term. In fact, their adoption at the time of fiscal retrenchment during the progress toward EMU might cause strains.

The level of aggregation in MULTIMOD did not permit isolating the impacts of the EMU process on non-EU countries, the Director explained. The issue could be addressed in the course of the Article IV consultations.

The Chairman suggested that, after one year of analysis in Article IV consultations, the impact on individual countries and country groupings could be summarized in a staff study.

The staff representative from the Fiscal Affairs Department stated that MULTIMOD offered some flexibility in terms of grouping countries—for example, the staff had experimented with creating a group of European transition countries. Theoretically, the impact of EU convergence process on other countries would involve two competing effects: a negative effect emanating from fiscal consolidation which would tend to constrain EU imports from other countries, and a positive effect of falling interest rates. It would be premature to attempt to quantify the two effects at the present time, as the experimental work done to date had been only preliminary.

The Director of the European I Department turned to the question of compatibility of flexible exchange rates and a single market in Europe. The issue had come to the forefront in the wake of the lira depreciation relative to other European currencies. Viewed in a historical context, the depreciation had left the lira's real exchange rate vis-à-vis the French franc and the German mark at about the same level as it had been in the mid-1970s. No restrictions had been imposed on Italian exports to Germany and France at that time, and it would therefore appear that the lira's exchange rate movements in recent years should not jeopardize economic union—although one could argue that economic union was a more ambitious project than a simple common market.

Economic and financial market globalization could exacerbate exchange rate fluctuations, the Director allowed. In fact, an overshooting had occurred in the case of the lira—financial market expectations did not seem to reflect fully the Italian economy's competitiveness and the intended changes in fiscal policy. If the lira were to remain at the present level and if the government implemented its fiscal plan, Italy's current account—measured at full employment—would register a relatively large, persistent surplus. Once the market became convinced that the government's intentions would be fully implemented, the staff expected the lira to appreciate.

Mr. Mirakhor inquired whether European financial institutions had been actively preparing for EMU.

The Director of the European I Department replied that evidence from Germany, France and Italy suggested that banks were indeed making a major effort to prepare for the advent of EMU.

Mr. Schoenberg confirmed that German banks had made substantial progress in preparing for EMU. The intensity of their effort was increasing as they were trying to overcome bottlenecks in some areas.

Mr. Havrylyshyn indicated that progress had been occurring in the Netherlands, where the central bank had been working closely with commercial banks.

Mr. Kaeser asked whether the monetary union was indispensable for the proper functioning of the European internal market. If so, why had it not been a topic for discussion inside the North American Free Trade Association (NAFTA)?

The Director of the European I Department replied that the degree of integration provided for under NAFTA was not the same as in Europe. NAFTA provided for free trade only in goods and services, whereas Europe was striving to establish a fully functioning economic union which included free movement of labor and capital. Furthermore, dependence on foreign trade and, hence, sensitivity to exchange rate movements was more critical in the case of European countries than in the United States.

Mr. Grilli made the following statement:

Let me first express a "view from the Union" on the subject under consideration today, i.e. progress toward EMU, a view that is intended to reflect shared perspectives and the common ground that now exists. I will then express the more specific views of my chair on the paper itself and on the important questions it raises.

Continued progress toward monetary union is of great importance to the EU. Monetary Union is an ambitious goal and also a very difficult one for independent states to reach. It involves giving up a great deal of monetary sovereignty, which is a delicate and sensitive matter everywhere and at any time. It is, therefore, not surprising that as the EU approaches this critical juncture the internal debate over the monetary union becomes more focused on the economic issues at stake and at the same time more political in nature. I would be surprised if it were otherwise. It is easy to foresee that the debate will continue until Stage 3 is started, and probably even beyond that point.

Precisely because of the importance of the project, and of the recognized difficulties that are attached to it, the approach to the monetary union that was agreed upon by EU members is a gradual one, but it is based on the shared belief that, prior to the final step, strong convergence among the economies of the member states has to be achieved. It was agreed—and so it remains—that monetary union must be carefully prepared and that a minimum number of access conditions be clearly specified. This agreement stands as the path to Stage 3.



The fixed points of this path are that (1) convergence needs to be high before the monetary union is started, in particular in the fiscal area and in the area of prices; (2) convergence must be durable, i.e., the conditions that lead to convergence need to remain in place after the start of the monetary union; (3) the process leading to Stage 3 must be transparent; and (4) the assessment of convergence must be objectively based. These are strong common points which are widely shared.

Obviously, the path toward monetary union is not set in a vacuum. It must take into account the continuously-evolving nature of the European economy, the social conditions in each of the member states, and the political debate, increasingly-evident and pointed in each member of the Union as time goes by, over the consequences of the possible outcomes of the convergence process. Quite naturally, tensions have developed between some of the key objectives that are now taking shape as Stage 3 approaches.

It is, for example, quite clearly understood that the number of countries able to join the monetary union at its inception constitutes a factor having possibly a strong influence on its chances of success. To be credible, to function well, and to last, the Union needs to be sufficiently large at the start. Nobody knows what is strictly sufficient, but as the staff paper indicates the initial membership should be "as wide as possible." It is also evident that there exists a political impetus for adhering to the timetable that has been fixed to reach Stage 3. Deviating from it in any substantive way would pose serious cohesion risks. At the same time, it is well understood, and the staff papers illustrate this with clarity, that various EU members are at different stages in their preparations for Stage 3 and at different distances from the pre-agreed starting conditions, a distance that depends, in part, on their individual starting points, in part, on their policy determination, and, in part, on the economic context that they face. In these circumstances, tensions are inevitably created among the objectives of maximizing the initial membership, keeping to the time table that was fixed, and adhering to a strong set of criteria for lasting convergence.

There is, however, a strong determination to overcome the hurdles that lie ahead. There is also a shared belief that the specification of the preconditions for joining the monetary union has had a positive effect in encouraging members to move toward them. This is particularly evident in the area of fiscal consolidation where considerable progress has been achieved, though much remains to be done in several individual cases. There is also a shared commitment to the time deadline that was chosen for the beginning of Stage 3 as well as the common knowledge that the process for interpreting the decisions made and the paths that were traced out exists within the Treaty.

This much for the shared common grounds. There is also a statement by the Commission that lays out its views on some of the key issues raised by the staff paper that was circulated to all Board members.

For my part, I want to say at the start that the staff paper is most welcome in time and substance. It is not only highly informative and topical, but it also attempts

to shed light on critical issues such as the relative merits and effects of different strategies for fiscal adjustment inside the Union. It also raises very important questions that remain open as Stage 2 comes to a close and the prospects for Stage 3 become more and more concrete, such as the exchange rate arrangements between the Euro and the currencies of the countries not yet participating in the monetary union in 1999 and the possible trade-offs between fiscal surveillance in Stage 3 and convergence criteria at its outset.

The paper examines several fiscal convergence paths (or scenarios) in 1996-97 and shows that both front-loaded adjustment (scenario A) and gradual adjustment (scenario C) have similar (and not so large) negative effects on growth in the short run, i.e. on the average of the 1996-97 period, and similar (and not so large) positive effects on growth over the period to 2000. They also show for the higher deficit countries, i.e. those that will have to bear the highest adjustment costs, that, if credible, gradual fiscal consolidation would mean lower short-term cost, in terms of foregone growth, than frontloaded adjustment, and no significant loss in the medium term either. Obviously the key assumption is credibility, which can be almost assumed in case of frontloaded adjustment, but cannot in a gradual process of fiscal consolidation. The market risks of the latter course are clearly greater than those of the former, but they may not be overwhelmingly so. The paper does not pronounce on this issue. What the paper does show is that frontloaded adjustment, at least for higher deficit countries, is not the only way to go, though it appears—on the whole—to be manageable and less risky than a gradual approach. Yet, the decisions on how quickly to adjust will necessarily be individual country decisions. For the higher deficit countries—and there are several in my constituency—they will also be increasingly difficult, given that, for most of them, they come at the end of a period of prolonged fiscal adjustment, which has reduced margins and made more challenging the final stretch of the road, particularly if the overall economic conditions of the EU (and the world economy) become less favorable in the next couple of years, a prospect that unfortunately we cannot too strongly discount at this point.

For some of the EU member countries it may not be possible to join the monetary union in 1999, but a number of them may well be close to meeting the convergence conditions and be seen to be in the process of meeting them. For these countries, the problem of exchange rate arrangements with the Euro will inevitably arise. This issue is indeed being actively discussed right now inside the Union. There is no question in my mind that a strong and narrow tie between the currencies of the countries not yet in the monetary union and the Euro can only be established if there is a strong commitment to intervene, and symmetrically, by the all the partners in defense of parity rates, or to keep exchange rates within the parity bands that might eventually be established. This would be necessary to convince countries not yet into the monetary union to lock into the common exchange rate system since the start of Stage 3, to sustain their commitment during a phase that might be difficult from the standpoint of exchange market conditions, and, I believe, also to keep the monetary union credible at the start.

Once in Stage 3, the question of compatibility between the common monetary policy and members' still-autonomous fiscal policies will necessarily

arise. Naturally, there must be a considerable degree of coherence of fiscal with monetary policies inside the Union. However, strong surveillance might be advisable. There are two issues here: (a) around what principles should such surveillance be organized (e.g., around a budget deficit norm, with permissible deviations) and (b) by whom should the surveillance be exercised. The determination of the organizational principles for fiscal surveillance in Stage 3 and beyond is still to be made. We can see the need to establish norms, but these should have a certain flexibility and be adjustable for the economic cycle. On the "surveillant," one could see a mixed role between the Fund and EU institutions (the European Commission, for example) at least for a while. It is clear, however, that as the monetary union becomes established, internal coordination of fiscal policy becomes more automatic and perhaps internally-supervised, when in other words the union takes on more and more the characteristics of a full economic union, the surveillance role of the Fund will have to shift progressively to the EU as a whole, for the external effects of its policies and performance. But, this is a long-term outcome.

This is what I wanted to say, from the vantage point of the Union and from that of my own chair. I expect that these views will be enlarged, enriched and debated during today's discussion, by my EU as well as by my non-EU colleagues.

Extending his remarks, Mr. Grilli said that, as the monetary union became established, and as fiscal policies were articulated within a common framework, the Fund surveillance would have to shift from the individual countries to the union itself, because the policies of the union would be expected to exert major influence on the international monetary system.

Mr. Mirakhor considered that, in the absence of political union in Europe, the rationale for Fund surveillance of individual countries would remain unchanged. Furthermore, there were members of the Fund whose economies would likely continue to be affected by policy actions of individual European countries.

Mr. Schoenberg made the following statement:

I welcome the paper prepared by staff for this meeting. To my mind it is a good paper—comprehensive and concise. Against the background of mounting speculation on the economic and political consequences of success or failure of European monetary union, it appears useful to start off by putting the EMU project in the context of the overall process of European integration. Staff rightly notes that the commitment to monetary union is part of a broader political process directed at strengthening cooperation among member countries. Assessing the consequences if the project falters, staff predicts "chilling effects in other major (integration) initiatives," "currency turbulence and the risk of competitive depreciations," and a potential "unwinding of the convergence process." I would not deny that these risks exist. I would, however, argue that such an outcome is by no means inevitable. Ultimately, the economic policies conducted by members matter, with or without monetary union.

One must not forget that economic and, in particular, trade integration have been progressing successfully for decades in Europe not only in the absence of

institutional monetary integration but even in the face of several earlier unsuccessful attempts in this direction. More importantly, perhaps, market-related monetary integration, i.e. the removal of barriers in the market, for instance barriers to competition, has been going on successfully in Europe for a long time without institutional monetary integration, leading initially to full convertibility of the European currencies and later step by step also to the removal of all capital controls. Finally, it is worth mentioning that the European monetary system (EMS), after frequent initial realignments in its early stages, brought about a remarkable stabilization of exchange rates and a notable lowering of inflation in Europe by the end of the eighties even though the "institutional stage," which was originally envisaged to follow, never materialized.

Having said that, however, it is also important to state that EMU is the next logical step in the European economic integration process. Only through EMU can the potential of the single market be fully realized. EMU is also Europe's strategic response also to the rapid globalization of financial markets, the growing interdependence of the national economies and the intensifying deepening of the international division of labor.

A second major aspect is the importance of EMU for countries outside the EU. Also in this respect, I basically agree with the conclusions of the staff paper even though I find the staff's considerations not complete. Certainly, EU membership is, for instance, for many transition economies in Europe—an important "lodestar"—and success of the EMU project would make the Community even more attractive to them. On the other hand, the requirements for full participation (which all existing members except Luxembourg find difficult to satisfy) obviously will establish additional hurdles for the newcomers. In so far, EMU will—at least initially—sharpen the conflict between deepening and widening of the Community.

I would also argue that the transition countries in Europe are at this stage probably above all interested in access to the EU markets and that it would be in their interest not to fix their exchange rates as long as the process of dramatic structural changes in these countries is going on.

Also the staff paper does not say much on some of the issues which may be of substantial interest to other non-EU countries, for instance, the question whether EMU will make the Community more open or not and what might be the implications of the single currency on the structure of the exchange rates among the world's major currencies. After all, the establishment of a single European currency is being anticipated by many observers as the most fundamental change to the international monetary system since the demise of the Bretton Woods system.

Lastly, a remark on the anticipated growth and employment benefits of the monetary union. True, a single currency would reduce transaction costs and abolish exchange risks in Europe, thereby enhancing competition in the goods and labor markets enhancing investment, improving the allocation of capital and adding to employment. I would argue, however, that much of the expected benefits will depend on how open the Community will develop over time, how determined the

existing structural rigidities, particularly in the labor markets, will be tackled by members and how successfully the inherent tensions between deepening and widening of the Community can be overcome.

After this somewhat lengthy introduction my further comments will follow the "topics for discussion" suggested by staff. I will limit myself to some of the core questions regarding EMU, since both Mr. Grilli's statement and the statement of the European Commission make a detailed repetition of all aspects necessary.

Slower versus faster paced adjustment: there is no doubt on our mind that faster paced adjustment will not only increase the number of initial participants in Stage 3, but that it is also necessary in its own right. The current fiscal positions in many states of the EU are unsustainable; with or without monetary union, these deficits have to be brought down quickly and decisively. A relaxation or slowdown of convergence efforts would not only harm the credibility of the process towards monetary union, but also undermine the future sustainable growth potential. Contrary to staff we see only limited room for additional monetary policy actions in the so-called "core" countries. Short-term interest rates are already near historic lows in many members of the potential "core" group. A further lowering of interest rates to spur growth may be counterproductive if this would accelerate the already visible increase of long-term interest rates, which, especially in Germany, have a much bigger impact on economic activity than the rates controlled by the central banks. This does not exclude some further interest rates easing if this should be warranted in view of developments of monetary aggregates and the price level. Until the beginning of Stage 3, however, the top priority for national policies is to keep "their own house in order."

In regard to the EMU process, this chair has often pointed to the potential conflict between a timely start to Stage 3, the fulfilment of the convergence criteria and the number of countries initially qualified to participate. We do not believe it is productive, however, to cross this bridge before we reach it. It is possible to hypothesize for hours on how such a potential conflict might be resolved. The only constructive approach at the moment is the firm commitment of every single member of the European Union to work as hard as possible to achieve the fulfilment of the convergence criteria during the next two years. Any relaxation of these convergence efforts would be most unproductive, and would, as the European Commission—expressed by Mr. Ravasio's statement—notes run counter to both the letter and the spirit of the Treaty. As I have mentioned before, the process of European unity is much larger than monetary union and will certainly not be thrown off track by a temporary growth pause in European economies. Turning to exchange rate arrangements, the Treaty is absolutely clear that the conduct of domestic monetary policy lies strictly with the domestic authorities until the beginning of Stage 3. This clearly prevents the introduction of any additional intervention obligations over and above the existing mechanisms. The question of the nature of the exchange rate arrangements linking EU countries not participating in Stage 3 with the "core" is indeed an important one. It will most certainly be necessary to differentiate between countries, especially if we include the number of possible new members from eastern and southeastern Europe. A "one fits all" exchange rate arrangement will certainly not be the answer to the diverse starting

position of the different countries not participating in Stage 3 from the beginning. Concerning the need for tighter surveillance of fiscal policies in Stage 3, it is well known that Minister Waigel has proposed a stability pact which would require member states to keep the average deficit below one percent of GDP over a business cycle. The work on the details of the fully stability pact has begun as requested by the European Council in Madrid. All EU member states have accepted the concept and its importance for a well functioning monetary union. The economic and political reasons for such a stability pact are overwhelming. Together with a strict application of the conversion criteria it will provide a sound basis for a successful monetary union. As I said before, we do not feel that the conversions criteria, and by those I do not only mean the debt and deficit criteria, but also the interest rate and exchange rate criteria, leave much room for any other than a strict interpretation. There is neither a "hierarchy" among the performance criteria nor is there room for "trade-offs" between these criteria or between the criteria and a prospective strong surveillance of fiscal policies in Stage 3. Entry criteria and surveillance in Stage 3 serve different purposes. Also on that issue the Ravasio statement is refreshingly unequivocal.

It is impossible to define a priori a specific "room for interpretation" of the performance criteria. And if it were possible it would not be advisable to speculate about it because that would only weaken the adjustment efforts in the Community.

As to the role of the Fund, for the time being we do not envisage any changes concerning the role of the Fund via EU members in general or Stage 3 participants in particular. This will certainly change once political union has been achieved in Europe, but that is probably still some way off. It is obvious that the Fund will continue, as it is already doing, to include the special effects of this regional corporation into its general surveillance. One interesting aspect the Fund might want to look at in the long term is the fact that all current EU members are Fund creditors and that a combined European quota will be much smaller than the addition of current EU quotas thus meaning less financial resource available to the Fund.

Extending his remarks, Mr. Schoenberg stressed that faster paced adjustment was preferable to slower adjustment, not only because it would increase the number of initial participants in Stage 3, but because it was also necessary in its own right. The current fiscal positions in many states of the EU were unsustainable and—with or without monetary union—those deficits had to be brought down quickly and decisively. A relaxation or slowdown of convergence efforts would not only harm the credibility of the process toward monetary union, but would also undermine the future sustainable growth potential.

In contrast to the staff's views, Mr. Schoenberg said he saw only limited room for additional monetary policy actions in the so-called core countries. Short-term interest rates were already near historic lows in many member countries of the potential core group. A further lowering of interest rates to spur growth would be counterproductive if it accelerated the already visible increase of long-term interest rates which, especially in Germany, had a much more significant impact on economic activity than the rates controlled by the central banks. That did not exclude some further interest rate easing if warranted in view of developments of

monetary aggregates and the price level. Until the beginning of Stage 3, however, the top priority for national policies was to keep their own houses in order.

Turning to the EMU process, Mr. Schoenberg pointed to a potential conflict between a timely start to Stage 3, the fulfillment of the convergence criteria, and the number of countries initially qualified to participate. However, it would not be productive to hypothesize on how such a potential conflict might be resolved. The only constructive approach was for every single member of the European Union to work as hard as possible to achieve the fulfillment of the convergence criteria during the next two years. Any relaxation of these convergence efforts would be most unhelpful and run counter to both the letter and the spirit of the Treaty. The process of European unity was much larger than a monetary union, and would not be derailed by a temporary growth pause in European economies. The conversion criteria—not only the debt and deficit criteria, but also the interest and the exchange rate criteria—did not leave much room for any other than a strict interpretation. All the criteria were equally important and the achievement of one could not compensate for the nonachievement of another. Nor could there be a trade-off between the criteria and the prospective strong surveillance of fiscal policies in Stage 3. Entry criteria and surveillance in Stage 3 served different purposes.

Turning to exchange rate arrangements, Mr. Schoenberg pointed out that the Treaty was absolutely clear that the conduct of domestic monetary policy lay strictly with domestic authorities until the beginning of Stage 3. That prevented the introduction of any additional intervention obligations over and above the existing mechanisms. The question of the nature of the exchange rate arrangements linking EU countries not participating in Stage 3 with core countries required a differentiated approach. A one-fits-all exchange rate arrangement would not adequately reflect the diverse starting positions of the countries not initially participating in Stage 3.

Discussing the need for tighter surveillance of fiscal policy in Stage 3, Mr. Schoenberg referred to the Federal Minister of Finance for Germany, Mr. Waigel's, stability pact proposal, which would require member states to keep their average deficit below 1 percent of GDP over a business cycle. The work on the details of the stability pact had begun, as requested by the European Council in Madrid. All EU member states had accepted the concept and its importance for a well-functioning monetary union. The economic and political reasons for such a stability pact were overwhelming. Together with a strict application of the convergence criteria, they would provide a sound basis for a successful monetary union.

Finally, the role of the Fund was not expected to change as a result of EMU, Mr. Schoenberg said. Only the achievement of political union in Europe could lead to changes in the Fund's relationship with European countries, but that was likely still some way off. The Fund would continue to incorporate the special effects of regional cooperation into its general surveillance.

Mr. Autheman made the following statement:

I see this seminar as a unique opportunity for us European members to listen to the views of our colleagues. We Europeans are knowledgeable about the issues; but it is useful for us to listen carefully to the concerns of our colleagues, who may point to issues of inconsistencies or weaknesses which are of great interest for all of us. However, I think that I have also the duty to say something, since this historic

endeavor is one which my country considers as important as the creation of the European Community in 1958. As Mr. Schoenberg said, we see it as part of a process which was launched then and which we hope will sometime in the future lead to some form of political union. Of course, there is a healthy debate, to quote Ms. Lissakers, as is natural in democratic countries. Mr. Grilli has very well laid the common ground, so I will restrict myself to specific comments on the main issues for discussion.

On the first point, which is the relative merits of slower and faster adjustment paths, we agree that in theory there can be a case for a slower adjustment path. The difficulty, as well pointed out in the staff report, is the credibility risk associated with a slower path. While one can measure the mechanical effect of a slower path, one cannot measure its impact on credibility. So, although I find the simulation very useful, I find it difficult to base specific policy advice on it.

I would rather emphasize the need for countries which do not expect to be able to be ready in time to meet all of the criteria to try to limit the credibility cost of such a delay by offering prospects for reasonably rapid convergence. What would appear a slower path of convergence may have limited credibility costs if the prospects for rapid convergence are reasonably strong, and the timetable is as precise as possible.

On the second issue, related to the effect of the uncertainties in the economic outlook, I would not like to repeat the discussions we have already had twice since the beginning of the year. We are well aware that the slowdown which occurred during the second half of 1994 makes the challenge more daunting and more difficult. However, we should not underestimate the fact that the efforts in the area of fiscal consolidation have to be implemented against the background of a very favorable policy mix, which is something new when compared to the previous years: low inflation in almost all European countries, no signal that inflation might resume in the medium term, and historically low interest rates. Therefore, the growth prospects may be not as bad as we may wisely foresee them to be today.

Turning to the EMU process itself, I share the disappointment expressed by Mr. Schoenberg on the way the staff paper addresses the issue of criteria. Indeed, I find the staff very articulate in providing to European countries the answer which it has always refused to provide to us, and lastly to Mr. Kafka during our retreat, about how to assess waivers to performance criteria. Staff answers have always been: we will decide ex post; ex ante it has only one stance: performance criteria are there to be met. Likewise, those who will have to make the decision in Europe have one credible stance only, which is to repeat that performance criteria are there to be met.

There is more than discipline and strict adherence to the Treaty in this strong emphasis on the need to interpret criteria strictly by EU members. What is at stake is a major credibility challenge. The decision to join the monetary union has to be endorsed by markets as a credible and reasonable one, relying on sound prospects of lasting monetary stability. The strict adherence to the criteria is crucial in this regard.



The second point I would like to emphasize is that fiscal consolidation is not a mechanical process. One does not achieve the most probable target because one has said that this is the most probable target. It is a dynamic process. One achieves the best result because one has assigned oneself the most ambitious objectives, consistent with what one can achieve.

Turning now to the exchange rate relations between countries which will join the monetary union from the first day and countries which will not be able or willing to join, I would like to say that this is a matter of common interest for all European countries. There is an obvious interest for the members of the monetary union to prevent an erratic process of overvaluation of the Eurocurrency, which would weaken the capacity of the European Central Bank to conduct monetary policy, and which would also raise protests on the part of the business sector..

There is also a major interest for other countries to protect themselves against too-high risk premiums, to borrow the credibility of the EMU itself, and to strengthen the prospects for their joining the EMU later. Of course, there is a great variety of situations in this group of countries which we cannot identify as of yet. Therefore, we need to find both a consistent framework and a differentiated approach, taking into account the specificities of each country.

Another important issue is the question of the stability pact. Mr. Arthuis, the Minister of Economy and Finance for France, warmly welcomed the initiative taken by Mr. Waigel last year. We were concerned by the fact that the view had developed too much among European public opinion that 3 percent of deficit was not a ceiling but a normal stance. I remember very well how this 3 percent figure was adopted. It partly came out of a judgment that, since France in 1981 and 1982 had never reached that level, this was the highest tolerable figure one could conceive of. Therefore, we need to restore the understanding that the normal situation is a deficit much lower than 3 percent. That is what is at stake in the discussion of a stability pact.

I have one final comment on the role of the Fund. We expect the Fund to play its normal role. We consider that in the two to three years to come the assessment of the consistencies of European countries' macroeconomic policy will be a central issue of Fund surveillance. Later on, as early as possible, we also expect the Fund to help both European and non-European countries to understand the consequences of this major change in the international monetary system and to better prepare themselves for the new situation which will result from it.

Mr. Mesaki made the following statement:

I found the staff paper very interesting and would like to request that the staff prepare papers occasionally on EU issues. The following comments are based on the topics for discussion described in the staff paper.

First, on economic policies in the near future, the key word will be "credibility," especially that of fiscal policy, as mentioned often by the staff. The simulation using MULTIMOD concludes that, if credibility is maintained, the

European economy will be better off in the medium term, with no severe pain in the short term, which is very encouraging. Concerning how to secure credibility, I do not see any difficult idea. Whether a country sets the goal in 1997 or later, it should embark on fiscal consolidation that exceeds market expectations and is backed by concrete and permanent measures, make a strong commitment as to the future plan, and immediately take compensating measures once consolidation gets off track.

The difficulty comes from the European economy's recent slowing down. Since this economic slowdown inevitably leads to a widening fiscal deficit, it may risk becoming a vicious circle in which expectations—of additional consolidation measures or of the increased possibility that the Maastricht criteria will not be observed—will increase economic uncertainties. Theoretically, the remedy at present seems to be a combination of strengthening fiscal consolidation efforts, as required by the economic slowdown, thus avoiding the deterioration of credibility of fiscal policy, and using monetary policy more actively, thus supporting the economy. In this respect, I find convincing the argument that monetary policies may be fully effective only if they are coordinated and that isolated actions may not bring about expected results. Having said that, it remains to be seen whether a theoretically appropriate remedy is actually feasible or not. Further consolidation measures may be politically difficult in some countries, especially if the economic slowdown proves steep.

Turning to the EMU process, EU countries, if they prefer, can maintain the principle of maximizing the number of participating countries to the EMU subject to the constraints on timing and qualification criteria. In reality, however, since the economy is slowing down, there is a possibility that the number of participants will decline. This trade-off is a very European issue, and it is difficult to make any specific comments from the outside. Nevertheless, one can perhaps say that, if this trade-off proves very sensitive, EU members should decide at an early stage—before they face high tension in the market—whether they will ease the condition of timing, that of qualification criteria, or both. In this regard, adopting a flexible interpretation of the gross debt criterion and the exchange rate criterion, including that on membership in the exchange rate mechanism (ERM), may not cause serious damage, but this is difficult to assess.

The staff's argument on the need for stronger provisions concerning intervention obligations and the coordination of monetary policies after a decision to move forward with Stage 3 seems convincing. The tendency among participating countries to intentionally welcome the depreciation of their currencies before their fixing cannot be ruled out. At the same time, I cannot see a strong reason why a tight relationship is needed between the Euro-currency and the currencies of the countries not qualified for Stage 3. The reasons for maintaining a wide band now seem to apply to nonparticipants' currencies in the future.

Concerning surveillance of fiscal policies in Stage 3, I tend to agree with the argument calling for tighter surveillance, although this is also primarily a European concern. The countries that failed to participate in Stage 3 because of the nonobservation of fiscal criteria would not like, perhaps, to see the deteriorating

fiscal positions in initial participants. Moreover, an appropriate balance may be needed with the unified monetary policy in Stage 3.

Finally, on the role of the Fund, there will be cases in which the Fund's advice facilitates the smooth transition to Stage 3. An example mentioned in the staff paper is the emphasis put by Fund staff on labor market issues, which I think is very important. At the same time, however, we should also note that the movement toward the EMU has various political elements and, therefore, advice by the staff as economists may have only limited validity. Rather, from the viewpoint of an outsider, the Fund should pay due attention to the impact of the EMU process on economies outside the EU. I am concerned, for example, that, if the need for international reserves declines among European countries after the transition to the EMU, it may bring about disturbing effects on exchange rates. At the same time, the emergence of the Euro zone may develop a new possibility for worldwide currency stabilization. For that purpose, even closer cooperation among the EU, the United States, and Japan in the framework of G-7 meetings or Interim Committee meetings will be an important issue to examine. In addition, considering that globalization and regional integration develop at the same time, cooperation between the Fund and the regional organizations—not only the EU but also NAFTA, Asia-Pacific Economic Cooperation (APEC), and others—will be all the more important.

Furthermore, the Fund should start examining the effects of the EMU on its own operations. This subject has many themes, such as the effects of the introduction of the Euro on the SDR basket and on the operational budget. It is important to list the possible themes at an early stage and to study them steadily.

Mr. Fernández made the following statement:

Let me start by saying that I consider the European economic and monetary union, essentially, a political project. It will also be an economic union, not just a monetary union alone. However, political and economic objectives need to be consistent with each other. The Maastricht Treaty was very carefully negotiated and has been ratified by all European Parliaments. The Treaty must be taken and respected as it is by all countries concerned. This is a right and an obligation at the same time for the signatories of the Treaty. The Treaty embodies clear rules to participate in the economic and monetary union. These clear and transparent rules of the game are also a guarantee for every member country not to be arbitrarily excluded. Therefore, I do not see any need to rewrite the Treaty, at present, by trying to provide ad hoc interpretations on the Maastricht criteria. The authentic interpretation of the criteria and the decision on which countries will be part of the EMU from the beginning will be done by the European Council in accordance with the Treaty with the margin of maneuver provided by the Treaty, and taking into account the political momentum in 1998. In the meanwhile, the authorities should not be distracted from their main responsibility of fiscal consolidation by messages such as the one I have gotten from my reading of the staff paper on progress toward EMU.

I am worried about the discussion on the interpretation of the Maastricht criteria in the staff paper, for several reasons. First, because I disagree with the view taken by the staff on the lessening of the importance of both the stock of debt and the exchange rate criteria. And, second, because I do not believe that the clarification of the requirements to be part of the monetary union now may have the merit of allowing markets more easily to judge the convergence status of countries and thereby to avoid tensions related to change sentiments on interpretation. On the contrary, trying to interpret the convergence criteria today is a futile and dangerous exercise which does not serve any practical purposes, in my view. And, in this regard, it does not matter if the interpretation is in the direction of lessening or strengthening the criteria.

The authentic interpretation will be done by the European Council in 1998, eventually using the room of interpretation provided by the Treaty itself. Discussions of these matters in Brussels or Frankfurt, mentioned by the staff paper, are of a tentative nature, because neither the Commission nor the European Monetary Institute have the option of making what in the continental legal system is called the authentic interpretation of the criteria, which is the relevant one. In this regard, I am worried about the possibility that the staff paper could leak to the public, because it will be interpreted as the views of the Fund on this matter.

In sum, I believe that the Treaty must be taken as it is, since a premature and open discussion on how to interpret the criteria could be very damaging. At present, I can only say that, first, the flow and stock of fiscal criteria are equally important with or without the stability pact. Second, that the letter of the Treaty is clear concerning the exchange rate criteria. A two-year participation in the EMS is a necessary requirement. And, third, concerning the price stability and interest rate criterion, the simple average over the three countries with best inflation performance will be used, period.

Regarding the discussion on the exchange rate regime between in and outs, the staff paper deals in detail with the ongoing discussions on the issue within the European institutions. As it is the case with the interpretation of the criteria, it will depend very much not on today's economic and political circumstances but on those prevailing in 1998, and, in particular, on the number and size of the countries that will remain out. Nevertheless, let me just say that there is another view on this matter different from the one represented by the staff paper. This view will stress the difficulties in having different exchange rate arrangements depending on how close a country is to comply with the Maastricht criteria. The arrangement should have common features for all countries. Moreover, it will make little sense, given the past experience, to ask the "out" countries to unilaterally fix their currencies to the euro without the compromise of unlimited intervention from the European Central Bank. The alternative would be to preserve the existing EMS with informal or sporadic agreements on foreign exchange market interventions between the parties concerned.

The staff paper makes some comments on labor market conditions and EMU. It is clear to me that flexibility of wages and prices is the basic mechanism for economic adjustment when you have a fixed exchange rate. So it is not only the

labor market, but also the goods and services markets which need to be flexible. It is also true that the absence of labor mobility, makes more desirable the above-mentioned flexibility of factor markets. At the end, the key issue is to preserve a competitive position through increased productivity and costs moderation. But these are challenges for all economies whether inside or outside the EMU. So, I do not have any difficulty in agreeing with the view that life will be easier for everybody if we had more flexible labor and goods and services markets, in advance. The social and economic cost of tight monetary and fiscal policies needed will be lower, and the absorption of shocks would be easier, too. But that is also the case at present.

On the other hand, reforms of the welfare system are also required in most, if not all, European countries. These are reforms which will not have a direct impact on the fiscal accounts in the short term, but for the reasons discussed a few weeks ago in this Board, actions should be taken as soon as possible on this field. The so-called Stability Pact will push things in this direction. But again this is something that should be done with and without EMU.

Let me also briefly refer to the issue of the need for a central fiscal policy function in the economic and monetary union to facilitate the response to shocks. First of all, Article 103-A of the Treaty provides for a financial mechanism to deal with exceptional circumstances out of the control of the affected member. Does the staff consider this Article the embryo of a fiscal central function? There are some moral hazard problems involved in being too specific about such circumstances, or in developing the details of such a financial mechanism, ex ante. I agree with that. However, transfers from a central economic authority to make manageable crisis situations, beyond the responsibility of the national authorities, will not be only a signal of political solidarity among members of EMU, but a requirement for the EMU to be perceived by outsiders as stable and sustainable from the economic point of view.

It may be true that the recent unexpected revision in growth figures in the EU will make more difficult to comply with the fiscal criteria for some countries. However, in my view, this is not justification for lessening nor for loosening the criteria. I also believe that it would be advisable and desirable for political and economic reasons to take on board a significant critical mass of countries. Of course, the stronger the economic growth from now on, the easier to comply with the Maastricht criteria in 1998. A country like Spain, in which political parties in favor of EMU participation represent 92 percent of recently elected members of Parliament could and should be part of EMU from the beginning. It is true that the new Government that will come from the March 3 elections will need to proceed quickly with additional fiscal consolidation measures, but the starting point is reasonable and the political aim to comply with the Maastricht criteria is clear. In this respect, I disagree with the inclusion of Spain in the group of countries which need a significant fiscal effort. The initial convergence position of Spain is good, in relative terms, and compared with many of other countries we just need a moderate fiscal effort to comply with the fiscal criteria. Growth in 1996-97 is also expected to be stronger than in other EU partner countries. Gains in credibility, as measured by lower interest rates from today's high interest rate levels, will strongly improve

the already low level of the stock debt, of a country like Spain. This will not be the case, unfortunately, for countries presently belonging to the so-called hard core. In sum, the classification of countries regarding the gravity of today's fiscal positions in page 18, which by the way sometimes include Portugal in one group and sometimes in another, is biased by the underlaying assumption in the paper that the stock of debt does not really matter.

Before concluding, let me disagree with the staff when in page 21 of the main paper attributes the last realignment of the peseta in 1995 to the perceived inconsistency of fundamentals with market rates. It is well known that at that time almost all European currencies were very much under pressure due to the strength of the dollar, as can be seen in Charts 4, and 5 of the paper, so that turbulence was not a Spanish phenomenon. Some countries reacted, at that moment, with strong increases of interest rates. My authorities heavily intervened in the market, without the support from other central banks, but at the same time were not ready to increase interest rates. In sum, let me say that the staff proposition, in the second half of the second paragraph in page 21 is right, but, this time, the example provided to support it is wrong.

Mr. Andersen made the following statement:

I welcome this discussion and would like to commend the staff for the very concise and yet comprehensive paper on the EMU process. The paper dealt with issues of strong direct to my authorities—of course for the three Nordic members of the EU, where my own country, Denmark, has notified that it will not participate in Stage 3, but also the two Nordic countries outside the EU and the Baltic countries have a natural interest in following the process closely. One important function of seminars like this one is indeed that they provide a window for non-EU countries to have a close look at the prospects and problems connected with the EMU process. Let me add that there, of course, are other windows worth looking at with this purpose in mind, especially the large amount of material published by the EU institutions, including from the European Monetary Institute (EMI).

Like others, I find it almost impossible to comment on all topics and will therefore limit myself to a few thoughts on some of the broad themes in the paper. My task has indeed been facilitated by the circulation of Mr. Ravasio's statement, which I found to be a very useful contribution to today's discussion, not least because it includes a number of important points that I broadly share. I also share many of the views already expressed today by my European colleagues, including the so-called "shared common ground" referred to by Mr. Grilli in the first part of his statement.

I shall structure my remarks primarily around the three themes covered by the issues for discussion in the staff paper.

First, on economic policy issues, I found the simulations contained in the papers very interesting and am in broad agreement with the conclusions drawn by the staff. The results support strong, credible and frontloaded fiscal consolidation with emphasis on expenditure measures, i.e., a well-known policy advice given to a

large number of countries around the world by this institution. The analyses focus appropriately on how continued fiscal consolidation could pave the way for lower interest rates, and stresses that the measures needed to achieve convergence according to the Maastricht convergence criteria need not produce large output losses in the short run, and that the needed fiscal adjustment would be associated with more rapid growth in the medium term. I also note that the short-run and indeed modest negative effects on output may even be overstated in the simulations.

Furthermore, I would like to emphasize that, in practice, quick and decisive fiscal adjustments are, in many cases, necessary, not only in order to comply with the convergence criteria, but also because such adjustments are called for by themselves as part of sound economic policies, or, as noted by Mr. Schoenberg, faster pace fiscal adjustment is necessary in its own right.

Thus, when countries are faced with the need for adjustment and are considering the options of taking or delaying action on fiscal consolidation, in many cases the only choice that might prove feasible for countries, in practice, is to opt for quick and decisive adjustment. Otherwise the market punishment may be merciless and the growth outcome correspondingly weak.

Therefore, rather than looking upon the convergence criteria as a kind of a straight-jacket, they should be considered as an expression of the common aim of achieving a sound economic development where the values of exchange-rate stability, low inflation and sound public finances are fully recognized.

Let me now turn to the EMU process more generally. The Fund has a legitimate interest in analyzing this process because of its responsibility for surveillance of the functioning of the international monetary system, taking into account, however, that many of the main policy issues raised throughout the paper are currently under discussion in the EU and are, moreover, of a highly sensitive nature. It goes, of course, without saying that discussions like this one in the Board in no way can be seen as pre-empting any negotiations or discussions carried out within the EU—a point that is well presented and underscored in Mr. Ravasio's statement.

As to the relationships between countries which participate in EMU's third stage from the start and those who do not, the same caveat applies. We agree that it is crucial that the functioning of the entire single market is not impeded and that possible later accession to the EMU will be on similar terms as for those countries that joined from the start. Furthermore, I find it important to remember that both "ins" and "outs" participate in the convergence process and are subject to the same broad economic guidelines.

More generally, like Mr. Ravasio, I find it difficult to make a case for the idea that a less strict interpretation of both the exchange rate and fiscal criteria could be justified by an agreement on stricter surveillance in Stage 3. It can be discussed to which extent the staff paper does so, but suggesting a trade-off between such an agreement and a preannounced liberal interpretation or relaxation

of the convergence criteria runs counter to both the letter and the spirit of the Treaty. Thus, while generally being in support of efforts to establish mechanisms to secure budgetary discipline in the monetary union, I would like to emphasize that such mechanisms certainly can be a useful complement to the convergence criteria, but would make a poor substitute, as stated by Mr. Ravasio.

Furthermore, as much as it is exiting to speculate on the likely number of countries that will meet the qualification criteria for Stage 3 from the start, it should be realized that decisions at the end of the day are to be taken by European policy bodies against the background of the circumstances prevailing at that time, which may be both better and worse than currently projected. Thus, as noted by Mr. Schoenberg, it may not be productive to cross the bridge before we reach it. Here I would like to add that the fundamentals of the European economies do not seem to justify the excessive pessimism regarding the macroeconomic prospects that we are witnessing almost daily when reading the financial press. I think also Mr. Autheman alluded to this issue. In any case, a more subdued pace of expansion does not seem to change the policy challenges which EU members face, but the room for maneuver in certain areas may be reduced and, I guess, would be further reduced in the future if the level of ambitiousness should decline. In short, I find it of little interest to speculate further at this stage on the convergence criteria, the timetable or the number of full EMU members at the outset.

Let me conclude with four brief observations regarding the role of the Fund.

First, it is to my mind important to note that there is no conflict between the Fund's and the EU's surveillance; they both have the same basic aim, namely to promote better macroeconomic balance and, in the end, high sustainable growth. Thus, close contact between the Fund and the EU in this respect is natural, and this chair encourages cooperation on a technical level through an intensified informal dialogue between the Fund staff, the EU Commission and the EMI. In his statement, Mr. Ravasio points to that EU surveillance is an continuing process. Needless to say, the Fund shall, of course, also endeavor to be on top of developments, and a number of important improvements in that respect have indeed been agreed upon more recently. Mr. Ravasio also rightly emphasizes that while monetary policy is indeed the prerogative of national authorities throughout stage two, there is a long tradition of close cooperation in this area—in the EU—facilitated by fixed exchange rate arrangements for about a quarter of a century. The tradition of close monetary cooperation in Europe even goes back to the beginning of the 1960s when the Committee of Governors of EEC Central Banks was established as the framework for monetary cooperation, whereas the period for formalized general economic policy cooperation is somewhat shorter, but still quite long.

Second, on the important question on how progress toward EMU affects the role and scope of Fund surveillance, I find that the staff paper has outlined some avenues worthwhile to pursue. For instance, focusing future Executive Board reports on specific topics seems appropriate, as that line of choice seems superior in contributing to a deeper understanding of EU developments among the Fund membership, as opposed to more general discussions.



Third, bilateral exercises will continue to remain the most important form for surveillance of EU member states. As time progresses, regional surveillance by the Fund, already an important aspect, may take on increased importance as a useful supplement to bilateral exercises. Obviously, after the start of Stage 3, regional surveillance for EMU participants will become relatively more important. Increased emphasis on regional surveillance will improve the possibilities to follow developments in EU as part of the multilateral surveillance. Of particular importance in the regional surveillance is the impact of EU policies on countries outside the EU. There is also a role for the staff to provide regional information on EU as an input for Board discussions on global issues, for instance, in the context of WEO and World Economic and Market Developments (WEMD) reviews.

Finally, I would like to note that once the European Central Bank (ECB) has been established, I see Fund surveillance of EMU monetary and exchange rate policies as taking place in parallel with the surveillance of individual EU member states. Already from the outset, the Fund will also need to seek appropriate forms for a strengthened dialogue with the ECB. One dimension that will merit special attention will most certainly be the role of the Euro in the international monetary system and, in particular, the relationships between monetary and exchange rate policies of the ECB and those of non-EU Fund members.

Ms. Lissakers made the following statement:

This staff paper conveys the impression that the European Monetary Union is mostly about fiscal discipline. That is probably not far off the mark.

Fiscal convergence has always been understood to be an essential precondition for monetary union, if only to assure all participants that a common monetary policy would not be undermined by fiscal irresponsibility of individual participants. But fiscal limits are not just security blankets for Euro-Central Bankers. The staff paper demonstrates that the gains from monetary union are likely to come largely from fiscal improvements in individual countries. The staff simulations indicate that meeting or exceeding the three percent of GDP deficit limits by reducing government spending will, over the long run, significantly lower long-term interest rates and improve slightly long-term growth potential.

What I found most interesting was the expected pattern of the distribution of the gains from fiscal discipline. The countries which now pay the largest interest premiums over German interest rates stand to gain the most from fiscal discipline, as long as that fiscal discipline is strong enough to bring them into monetary union. Chart 6 indicates that the United Kingdom, Ireland, Finland, and Denmark, which are all at, or within striking distance, the Maastricht deficit target, and could each knock 150-200 basis points off their borrowing costs if they were able to finance themselves at German interest rates—the presumed standard for the new Euro. If such savings could be realized, that would be a very significant fiscal windfall for these countries. It would mean they could narrow their budget deficits with a smaller relative effort at reducing the primary balance.

Interestingly, Chart 6 indicates that the countries commonly thought of as core members of any monetary union—Germany, France, the Netherlands, Belgium and perhaps Austria—would not enjoy much of a reduction in interest rate premiums. In a sense, the countries that have been tracking the deutsche mark closely have already pocketed most of the gains from low premiums over German interest rates. There is little interest premium windfall left to be exploited. These countries will now have to satisfy the Maastricht requirements the hard way—by reducing their primary deficits. If the high deficit countries could find the means to get their deficits down enough to qualify for EMU, they would stand to gain the most in terms of reduced interest premiums.

The staff's simulations assume that all European interest rates peg off a German benchmark. Based on experience, this is a pretty good working assumption for now. However, I wonder if we should also expect this to continue to be true inside EMU, when German interest rates will reflect German risk without the credibility factor associated with the Bundesbank? Likewise, I wonder if the market's assessment of national credit risk might not be somewhat revised after EMU. The staff's calculations show that, now, default risk is a very small element in the interest rates paid by EU governments—perhaps no more than 50 basis points. Should we expect this to continue to be true for very heavily indebted countries once these countries no longer have a national central bank standing behind their credit ratings?

Since our previous discussions, it has been recognized more clearly that the three percent deficit standard should be viewed as a ceiling not a norm. The norm will have to be lower than the ceiling if there is to be scope for automatic stabilizers to come into play during cyclical downswings. On the staff's calculations, this means that most EU countries would need to be aiming not for a three percent budget deficit but rather for a cyclically adjusted balanced budget or even a surplus. The fiscal hurdle seems to get higher the closer we get to Stage 3.

In any case, it is clear there is going to be a lot of necessary long-term fiscal adjustment underlying EMU. The impact of that adjustment on short-run activity needs to be taken into account. I am not sure whether the results of the MULTIMOD simulation should be considered optimistic, pessimistic, or realistic. In the writeup, the staff states that a concerted, credible effort to reduce EU deficits to the 3 percent target by 1997 might penalize growth by  $\frac{1}{4}$  of 1 percent in 1996/97. This struck me as a pretty minor growth penalty. A closer look at Appendix IV, however, shows that the narrative is referring to a two-year period. The first-year impact of the suggested fiscal consolidation might involve a growth penalty of one percent. A noncredible effort would cost another  $\frac{1}{2}$  of 1 percent of GDP in the first year. In MULTIMOD these first year effects fade in the second year because lower interest rates promptly crowd in higher investment.

Clearly, you cannot get from here to there without absorbing these transitional costs. But the short-run contractionary effect from fiscal consolidation is strong enough that it raises the question about the right policy mix for the transition. What should monetary policy be doing during the transition? The staff report is silent on this point. EU officialdom also seems to be mute on this point. I

wonder if the staff or other European Directors have any thoughts on how monetary policy should be executed during the fiscal consolidation transition. Based on our recent experience in the United States, we believe the combination of credible deficit reduction and a well-designed monetary policy that anticipates future deficit reduction can avoid potential contractionary effects on the economy.

Greater labor market flexibility could, in principle, moderate the consequence of reduced policy discretion to deal with asymmetrical shocks at the regional or national level. This is well recognized. However, it is also clear from experience that we cannot rely on labor market liberalization to be a substitute for the role now played by countercyclical fiscal or monetary policy. Despite years of discussion, governments show little inclination to press reforms very far, very quickly.

I found the comparison of EU and Fund approaches to surveillance instructive. There are differences in emphasis and technique but we both seem to follow a similar play book. Still, there is a role for both of us. I am convinced, for example, that our more robust insistence on labor market reforms is to be preferred to the more diffident approach taken by the EU. Even so, I am not sure either of us is having much impact on this important dimension of policy. Regarding fiscal policy analysis, I suspect the EU analysis understates the transitional costs of fiscal adjustment. This is an area where a second look by the Fund is helpful, although I think the Fund itself is not giving enough emphasis to the need for a forward looking monetary policy to moderate fiscal drag.

Fund surveillance should rightly give a higher profile to the external, non-EU dimensions of EMU than does the EC. So far, both of us have only scratched the surface. The financial relations that will be introduced by EMU will have significant effects on international capital markets, financial flows, and institutional aspects that we need to begin evaluating. We also need to give the EU a prod to develop its own thinking in this area. More practically, we will need to pay very close attention to exchange market developments as the decision date for Stage 3 draws nearer. Many of the choices that will have to be made will be yes-or-no decisions. The possibility of discontinuous market reactions are significant, with possible disruptive developments in third markets.

Extending her remarks, Ms. Lissakers stressed the need to correct labor market rigidities if the problem of unemployment were to be satisfactorily addressed. In addition to labor market reform, further market deregulation and the dismantling of government-protected oligopolies was also necessary for attracting new investment. While welcome, monetary union should not be viewed as an end in itself—Europe would reap full benefits of its integration process only with a successful achievement of economic union. To that end, further structural reforms were essential.

The Chairman, acknowledging the seriousness of the unemployment problem in Europe, and noting differences between labor markets in Europe and in North America, expressed the hope that the G-7 summit on labor would go an extra step in an effort to synthesize the experience in the two regions.

Mr. Kiekens made the following statement:

The staff's stimulating papers provide a good basis for today's seminar, which is an excellent opportunity for the whole Fund membership to discuss the progress the European members have made toward Economic and Monetary Union. It is also a first step toward a better understanding of the implications of the EMU for the world economy. I am in broad agreement with the thrust of Mr. Ravasio's statement, as well as with the common ground marked out by Mr. Grilli. I will first recall the reasons why the EMU is both a natural and a necessary complement to the single market. I will then turn to the policies aiming at a high degree of economic convergence among the member states of the European Union, the procedures leading to the final stage of the EMU's establishment, and the surveillance role of the Fund with regard to the EMU and its members.

On the need for an EMU, let me begin by briefly reminding the Board that economic and monetary union is the next logical step in the process of European integration, and Europe's strategic response to the rapid globalization of the world economy. Exchange rate fluctuations among the currencies of the member states of the EU during recent years clearly show the need to establish an EMU. In the single market, exchange rate fluctuations can cause important distortions of competition. Consequently they may give rise to protectionist pressures, which put at risk the whole process of European integration. The only way to eliminate continued risk of exchange rate instability under conditions of free capital movement is to introduce a single European currency and to pursue a single monetary policy. The EMS crisis of 1993 showed that it is no use trying to preserve the status quo, since, even when macroeconomic indicators are converging, exchange rate stability cannot be ensured when the markets expect that economic performances are about to diverge. The mere existence of such expectations attaches a risk premium to interest rates in the member states of the EU. There is also a danger of triggering a vicious circle of competitive devaluations and protectionist retaliations.

On economic policies, the monetary policy of Germany is maintaining price stability, while the other countries of the core group have, as an intermediate target, linked their exchange rates closely with the anchor currency. These policies have earned a high degree of credibility in the financial markets. Given the sound fundamentals, there was room in 1995 for several cuts in official interest rates, and the outlook indicates that there remains some room for further minor cuts, although the recent rise in long-term rates calls for caution in monetary relaxation. In reply to Ms. Lissakers, who advocates further interest rate cuts in anticipation of further fiscal consolidation, I can confirm that further credible fiscal consolidation will indeed create room for further monetary easing. I would like to recall that last fall the Banque de France courageously decided to cut interest rates once it was convinced that the government was determined to implement further fiscal consolidation.

On policies needed to realize the necessary high degree of convergence, I agree with the staff's conclusions on the different adjustment scenarios. These confirm that credible frontloaded fiscal consolidation will bear fruit in the form of lower real interest rates. The scenarios also show that the initial slowdown of

economic activity resulting from fiscal consolidation in compliance with the Maastricht convergence criteria, will be limited and in the medium term will be more than offset by the benefits of the EMU.

The decline in private sector confidence and weaker growth performance that occurred in 1995, and the recent rise in long-term interest rates, may well stem, in part, from doubts that the fiscal consolidation will be accomplished soon enough to reach the convergence criteria. The markets may doubt whether the EMU will be established by the agreed time.

The staff correctly stresses that to deal with these market sentiments and to resume the recovery, confidence building is essential. Efforts to that end must not only provide reassurance that the fiscal adjustment will be sufficient to respect the timetable. They must also make clear that the short-term impact of these measures on growth will be limited. Since the staff scenarios disregard the positive effects on confidence that will appear, once it becomes clear that the EMU will be established on time, the short-term costs of credible convergence efforts may even be overestimated. Therefore, increased confidence could establish a virtuous circle of lower interest rates, higher growth, and better than targeted fiscal performance.

With respect to the EMU process, my position is much in line with that of my European colleagues. In December 1995, the European Council confirmed that the EMU's third stage will begin on January 1, 1999, and the need to reach a high degree of economic convergence by that date. To ensure a solid basis for the Monetary Union, the eligibility criteria must be strictly interpreted, with no weakening of the convergence criteria. Criteria calling for judgment under the Treaty require an evaluation of the durability of a candidate's achieved convergence. "Nonparticipants" should be encouraged to remain committed to participation and thus to meeting the convergence criteria as soon as possible. The ultimate goal of the EMU is to include all the countries that can be helped to meet the convergence criteria.

An exchange rate arrangement between the Euro and the currencies of the nonparticipants is an essential part of the strategy of continued convergence efforts by countries not able to join the Monetary Union at the start of Stage 3. To avoid uncertainty and instability, the general principles of such an exchange rate arrangement should be announced as soon as possible. This arrangement will take effect at the start of Stage 3.

Gradually, as economic convergence takes hold, the economic policy of the EMU will become more than a reference for the economic policy of the nonparticipating EU members. Linking the currencies of the nonparticipants to the Euro will encourage them to pursue policies resulting in increased convergence and price stability within the European Union as a whole.

This exchange arrangement should be flexible enough to accommodate differences in the degree of convergence. The experience of the EMS, which since the widening of the fluctuation bands is sufficiently flexible to avoid excessive pressures while at the same time promoting a high degree of convergence, forms a

good model, but will need to be adapted to the new environment. In designing this new exchange rate arrangement, a primary consideration should be to preserve price stability within the Monetary Union. The credibility of the single monetary policy aimed at price stability should be jealously guarded.

Budgetary consolidation is the main challenge facing member states. It must not only be consistent with the Maastricht convergence criteria but also prepare the countries to cope with the social and demographic challenges of the medium term. Reduction of public deficits and debts should go hand in hand with active policies to reduce unemployment, which lowers public revenues and raises public expenditures. More employment will foster public support for the Monetary Union and for the continued efforts the Union will require to maintain stability. These objectives require policy measures at both the national and European levels.

Member states must reinforce their multi-year employment programs following the recommendations of the White Paper on Growth, Competitiveness and Employment. Since exchange rate adjustment will no longer be available as a policy instrument for member states, the introduction of the Euro will have to be supported by making labor markets more flexible and keeping real wages in line with productivity. This is an essential requirement for the sustainability of the monetary union, as was rightly stressed by the Director of the European I Department at the beginning of the meeting and underlined by Ms. Lissakers.

To alleviate and even offset the inhibiting effects of fiscal consolidation, the European Commission should revive its promotion of pan-European networks. Establishing a European social dialogue based on a pact for employment, price stability and budgetary consolidation would reassure the European central banks that price stability remains at the core of economic policies, that governments remain committed to fiscal consolidation, and that the social partners are ready to accept wages linked to productivity and labor flexibility, which will favor job creation by enterprises.

To ensure that the economic fundamentals remain sound during Stage 3 of the EMU, member states not only need to have achieved low inflation, but also need to continue practicing budgetary discipline. Multilateral surveillance should therefore be strengthened. An early agreement on the surveillance procedures to be applied during Stage 3 will also reassure the markets.

The objective during Stage 3 is to bring public finances close to balance. Assuming normal rates of growth, this implies that debt to GDP will continue to decrease.

On the role of the Fund, the surveillance activities of the Fund and of the EU, although different, have broadly similar objectives. Both the Fund and the EU should therefore coordinate their approaches. The Fund should maintain a close watch over the ongoing EU convergence process in order to detect and head off potential market tensions in a timely and effective manner. I also agree with the proposed scope and format of future papers on EU issues, but would like to see more attention given to analyzing the effects of the EMU on the transition and

Mediterranean countries having an association agreement, or in the case of Turkey, a customs union with the EU.

Finally, the background paper on the conduct of monetary policy in the EMU provides useful information. The EMI and the central banks are working hard to finish, on time, the regulatory, organizational and logistical framework for Stage 3. Some issues are still unresolved, due more to the complexity of the integration rather than to lack of willingness.

Mr. Schoenberg expressed agreement with Mr. Kiekens's point on the importance of structural reform in Europe. Decisive structural reform in Europe could compensate for any short-term loss in growth resulting from the fiscal convergence process. Another related question concerned the role of wage differentiation to counteract regional fluctuations in economic activity. In the absence of the exchange rate instrument and in the absence of fiscal policy, the importance of wage flexibility would increase. Even though there was a theory that, following monetary union and the ensuing transparency concerning wage differences in Europe, there might be a tendency for regional wages to converge, such convergence would be unlikely to occur owing to the presence of barriers to migration.

Mr. Kiekens stressed that wage increases should reflect productivity growth if unemployment were to be kept from increasing. Also, while structural reforms were essential to ensure monetary union sustainability in the long run, they were unlikely to fully offset negative effects on employment of fiscal consolidation in the short run.

Mr. Grilli pointed out that, while reforms designed to enhance labor market flexibility and efficiency were essential to addressing the unemployment problem, they had to be complemented by stronger demand growth to produce meaningful reductions in the unemployment rate. Economic growth in Europe of 2 percent a year was insufficient to generate strong labor demand growth.

Mr. Kiekens agreed that faster growth was needed to create new employment, and that growth had to become more labor-intensive. That could only occur if the price of labor relative to that of capital declined. As the price of labor was affected also by the degree of labor flexibility, structural reforms promoting labor market flexibility and efficiency were crucial for halting and reversing the trend of substitution of labor by capital.

Mr. Schoenberg agreed with Mr. Kiekens that the best chance for growth in Europe lay in structural change which in turn would lead to higher investment, thereby producing both factors that Mr. Grilli was looking for.

Mr. Mirakhor, citing the experience of the United Kingdom and Ireland, expressed the view that structural reform could produce positive results in the short term as well.

Mr. Evans remarked that the U.K. labor market reforms, which had begun around 1980, had had a progressively increasing effect during the 1980s. While it could not be said that it had taken a long time before the reforms produced results, it had taken years for the full effect to become apparent. Indeed, many commentators were of the view that the full benefit of the reforms in the United Kingdom had not yet been reaped.

Mr. Havrylyshyn made the following statement:

We first thank the staff for an excellent and timely paper on a subject which leaves room for differences in judgment. We welcome the opportunity to have this well-timed discussion on the progress towards EMU, which progress can be summarized as follows. The technical preparations, undertaken *inter alia* by the EMI, are on track. The current economic situation has worsened somewhat relative to the expectations and may necessitate additional efforts to be undertaken by the national authorities in order to fulfill the necessary conditions for adopting the single currency, to achieve the high degree of convergence Mr. Grilli underlines in his first principle. It is of paramount importance for credibility that all predetermined criteria be respected.

Let me comment selectively and briefly on the discussion topics.

On policy actions today, the staff notes that progress towards EMU is characterized by uncertainty and they are right. But we do not find this uncertainty a surprise: it is to be expected for a process as complicated as this one. The surprise would be if we did not see uncertainties. Having said that, it is also true countries can help diminish the uncertainty by demonstrating their continued commitment to the creation of monetary union in line with the timetable and the Maastricht Treaty. This commitment should come not only from announcements, but also from firm, determined action, in particular in the fiscal area. Credible measures incorporated in a medium term program aiming at a deficit below 3 percent of GDP will be the most effective way to address the uncertainty in financial markets and elsewhere.

As Mr. Schoenberg I see difficulties with a public reassessment of the Treaty, as this may only add to the confusion. Discussions on a possible delay of EMU or a loose interpretation of the convergence criteria are counterproductive because they are premature. They undermine the political momentum for budgetary consolidation and thus monetary coordination.

While the current economic situation makes economic convergence more challenging, it does not affect the basic rationale behind the criteria. Although the Treaty, as any legal document, leaves scope for interpretation, it leaves no room for noncompliance. The objectives of the criteria are clear and credibility requires close adherence. My authorities consider it undesirable to try and clarify the debt provision at this moment. They would also like to point out that only member states with stable currencies can be among the first group. According to the Treaty, the commitment to a stable exchange rate should be underpinned by membership in the ERM.

As regards future challenges: exchange rate turbulence in the interim stage, there is a risk of exchange rate speculation in the interim period between the decision which countries will move to Stage 3 and the locking of their exchange rates. Therefore adequate arrangements among the group, possibly including strong intervention commitments, might be contemplated in order to avoid financial market tensions. In these circumstances, if the convergence criteria are applied



strictly and the selection of the first group is credible, speculation will in principle not be rewarding. Moreover, monetary policy decisions will to an increasing extent have to be taken with due regard to their effect on the monetary situation in Stage 3.

As to additional arrangements in Stage 3, when stage three is considered, one's mind naturally turns to the exchange rate relations between the first group members and those countries that do not yet participate in the monetary union. My authorities favor a multilateral exchange rate arrangement between the Euro area and the other currencies. However, we need to recognize, as Mr. Autheman noted, that this may be a heterogeneous group of currencies and it would therefore be prudent to differentiate between them in terms of modalities, for example—and only as an illustration—the width of the fluctuation margin around the Euro and the related intervention obligations. Mr. Mesaki posed a question on this which intrigued me: “why does one need a tight relation in Stage 3?” Perhaps the answer is in the semantics: for reasons of credibility it is important to have a tight mechanism, in the sense of clarity, and specificity of commitments; differences among countries can be reflected within this tight mechanism by differences in margins, modalities.

Another question regarding stage three is the need for tighter surveillance of fiscal policies in Stage 3. The desirability of this seems to be widely recognized at the moment. A lack of fiscal discipline in the member states would place undesirable strains on monetary policy. We fully share the concerns underlying the German proposal for a ‘stability pact of Europe’, the details of which are under study at this moment. An important element is an arrangement to ensure that the 3 percent deficit ratio acts as a ceiling and not as a target. In other words, the deficit should, on average, be close to 1 percent of GDP or even close to balance. This goal is not something new. The recommendations of the Ecofin Council on the broad guidelines defined a deficit of close to balance as the medium-term goal for the member states already in July 1995.

On the role of the Fund, I will echo Mr. Andersen's remarks here. My authorities are reasonably content with the way the Fund is going about its work. Fund surveillance and EU monitoring of member states' economic policies are mutually reinforcing. As the staff has stated on many occasions, most recently in the Belgian case, fiscal consolidation would have to take place with or without EMU to reduce the burden of interest payments and to deal with the demands of an aging population. In addition, Fund surveillance should also focus on the merits of exchange rate stability within the EU area. In this connection, I lend my support to the défi Mr. Autheman has put to the Fund, of helping make clear to the international community the nature of this important historical change in global monetary arrangements. The suggestion to focus Board discussions on the EU on specific topics rather than the whole range of issues also seems sensible.

Mr. Kaeser made the following statement:

The staff's assessment of the progress toward EMU gives us a timely and comprehensive overview of the issues and problems involved in the introduction of

a single currency in Europe. Very timely indeed as, according to the *International Herald Tribune*, the EU works behind the scenes to salvage its single currency plan. A debate on this issue is essential since progress toward EMU will significantly affect the development of the international monetary and financial system in the coming years. If the EU chairs welcome the opportunity to hear the views of outsiders, the outsiders are also very interested to hear the different EU chairs present their own views on this common project, with nuances which go far beyond the four gospels in the New Testament.

We acknowledge that the convergence criteria play an important role in rendering national monetary and fiscal policies more compatible. By explicitly requiring ambitious standards as regards monetary and fiscal policy, the criteria help to lay the foundations for a common monetary policy that will stress price stability and support a steady and sustainable growth path for EU members. Therefore, by encouraging progress toward sound public finances and stability-oriented monetary policy, the goals set by the Maastricht criteria are laudable in themselves, regardless of the final timing of Stage 3 of EMU.

Among EMU candidates remarkable convergence has been achieved in the areas of inflation and interest rates, while progress in the fiscal area has been less than satisfactory. The latter results have given rise to some doubt as to the possibility to achieve the Maastricht Treaty objectives. At present, the probability that a sufficient number of countries will satisfy a strict interpretation of the eligibility criteria seems to be rather small. Therefore, expectations about the timetable and the likely number of participants vary substantially, leading to growing unease for financial market participants. In order to reinforce the credibility of the project and preempt turbulence in financial markets, as the planned date for Stage 3 draws closer, strong commitment—but also sound realism—needs to be demonstrated.

As regards the issue of economic policy in the context of EMU, we agree with the staff on the central importance of the credibility element. In our view, market expectations—and thus their judgment on the credibility of a country's economic policies—are generally based on past behavior and observable facts. Therefore, transparent macroeconomic policies which have the public support necessary for being implemented are critical in order to earn credibility.

As the staff points out, most EU member countries will need to reduce budget deficits in the coming years, irrespective of whether EMU starts on schedule or not. Much will depend on the time frame in which the reduction in the budget deficits is to be achieved. If the target year 1999 for EMU Stage 3 is maintained in spite of the worsened economic outlook, fiscal adjustment will have to be accelerated immediately. As the staff simulations using MULTIMOD show, there is a strong economic case for such an acceleration in fiscal consolidation. This is even more so as these simulations do not take into account the positive effects of a successful EMU on financial market confidence and private sector activities.

However, one can have doubts about the ability of governments to implement the measures needed for such accelerated fiscal adjustment. Given the

high social and political costs of fiscal consolidation in times of economic uncertainty, it is indeed not obvious whether EU member countries are willing to make additional sacrifices for the sake of a timely start of EMU. This would be especially true, should Germany and France have difficulty in implementing the credible policies necessary for reaching the convergence criteria by 1997.

In our view, there is some danger that the close link now established between fiscal austerity and the EMU could be misinterpreted by the public. It should be made clear by the authorities that fiscal consolidation is necessary as such, with or without EMU. Using EMU as a scapegoat for unpopular fiscal measures could seriously endanger the realization of the project.

As regards the EMU process, if by 1997 the convergence criteria cannot be met by a sufficiently large number of member countries, the EU has essentially two options, namely: (1) interpret the convergence criteria in a flexible way, or (2) postpone Stage 3 of EMU.

A flexible interpretation of the convergence criteria could lead market participants to question the sustainability of the EMU. Since macroeconomic convergence is essential for a common policy geared toward price stability, failure to timely meet the initially scheduled targets could result in turbulence in financial markets and saddle the "Euro" with a high risk premium. In addition, capital outflows could create negative externalities in the form of significant exchange rate distortions for non-EU countries and, in the case of Switzerland, potentially destabilizing currency fluctuations. In our view, a flexible interpretation of the criteria is to be avoided, as well as the introduction of cyclical components into the convergence criteria.

The second option, a postponement of EMU, may not look attractive from a political point of view. However, adjusting the timetable would not mean abandoning the ultimate goal, but putting a future European monetary policy, from its inception, on a more solid and thus more robust basis. The possible loss of credibility, resulting from a delay, could be reduced by officially announcing the decision early together with a clear and binding schedule. Such frankness regarding the progress toward EMU would also reduce speculations as regards the stringency of the convergence criteria.

Independently from the starting date of Stage 3, a number of problems will have to be addressed well in advance. We would like to comment on three of them:

First, the staff stresses the need for clearer provisions concerning the intervention by EMU central banks in defense of a currency and the coordination of monetary policies among participating countries after the decision to move forward with Stage 3. Given that monetary policy remains a national prerogative until the start of Stage 3, ways have to be found which allow both for a close coordination of national monetary policies and for the observance of the Maastricht Treaty provisions.

Second, regarding exchange rate arrangements linking EU countries not—or not yet—participating in Stage 3 with the “Euro,” a case could be made for differentiating between countries that are close to qualifying for Stage 3, and the other countries. This differentiation does, however, not solve the basic trade-off which has been inherent in all exchange rate mechanisms between the member countries of the EU: if the European Central Bank is required to intervene in favor of nonparticipating currencies—as it would be in a symmetric system—the goal of price stability could be threatened; in turn, if the ECB is not required to intervene, the usefulness of the exchange rate mechanism would be greatly reduced. In our view, to find a solution to this problem should be one of the main objectives of the preparatory work over the next years. In this respect, one will probably have to draw on the experience of the Bundesbank, whose active participation in a system with symmetric intervention did hardly have adverse effects on the price stability in Germany.

Finally, the question of fiscal discipline in Stage 3 has to be tackled. Although not specified in the Treaty, a budget deficit of 3 percent of GDP should represent an upper limit. A more ambitious goal should aim at achieving a balanced budget over the business cycle. This implies that fiscal consolidation will need to continue after the fixing of exchange rates and the centralization of monetary policy. However, given that in Stage 3 fiscal policy will be the only policy instrument left for national governments to counter external and internal shocks, proposals for tightening the criterion on budget deficits should allow for enough flexibility in the conduct of fiscal policy.

As regards the role of the Fund, we do not see much scope for extending Fund activities beyond close monitoring and surveillance. However, these two functions should be performed to the fullest extent possible. We agree with the staff's intention to start focusing on specific EMU-related topics rather than addressing all relevant aspects at one time. One interesting issue would be the relation between globalization and EMU. We also look forward to see how the staff will analyze the impact of the EMU process on countries outside the European Union from a perspective of maintaining stable exchange rate relations. In this respect, the Managing Director is aware of the problems that these countries might have to face. To be frank, my expectations are modest in this respect. We know by experience that the Fund can do very little to protect small countries against the fluctuations of major currencies, with the exception of recommending them to follow sound economic, financial and structural policies, and to buy currency options if they can afford it.

With regard to the implications of EMU on the institutional framework of the Fund, we will cross that bridge when we come to it, but we can be sure that the devil will sit on it.

Mr. Kiekens volunteered to provide the Board with technical information on the necessary numbers of countries needed to start a monetary union. The Treaty on European Union provided two scenarios. According to the first scenario, the Council of the European Union would have to decide before the end of 1996 which members fulfilled the necessary conditions, whether there was a majority of members that fulfilled the necessary conditions and,

if so, when the monetary union would start, and whether it was appropriate for the community to enter into the third stage.

If the first scenario did not apply—and currently it appeared it would not—the rules were quite clear, at least in the Treaty, Mr. Kiekens continued. The Treaty said that, “. . .by the end of 1997, the date for the beginning of the third stage has not yet been set, the third stage shall start on January 1 1999.” The only point that remained to be decided was which countries fulfilled the necessary conditions for the adoption of a single currency. The Council following the Treaty might come to the finding that, for instance, only two countries, or even one country, fulfilled the conditions. While the number of members was not a condition for Stage 3, a serious political and legal problem could arise if only a country or two fulfilled the conditions, because a viable monetary union could not be built on that foundation.

Mr. Evans made the following statement:

I thought the staff papers were generally of very high quality, and that they did a good job of explaining outside the circle of the European Union the mysteries of this particular enterprise. Mr. Grilli set out very well the common ground among the members of the EU, and we certainly subscribe to the points that he made under that heading.

My remarks will focus the United Kingdom's interests and concerns related to EMU. Keen listeners may detect some of the nuances that Mr. Kaeser referred to here. The United Kingdom, of course, has a legal opt-out in the Maastricht Treaty. It is up to us to decide whether we wish to apply to join the monetary union. Unlike Denmark, we have not yet made our decision. But, like anybody else, if we wish to join monetary union, we have to meet the necessary convergence conditions. I think this option makes even better sense today than it did when we negotiated it five years ago.

The United Kingdom has not endorsed the conclusion that monetary union is always necessarily a “good thing” for the European Union. It may be, if the right conditions are met, but not necessarily. In particular, we have not accepted that monetary union is essential for the completion of a single market. But the United Kingdom has not opted out of the discussions or decisions that are being taken on the road to monetary union. In particular, we have taken a constructive role all along.

To summarize our views very briefly: we see the economic convergence conditions as essential for successful monetary union; we do not want to see any weakening of the criteria; we see no need to interpret them before decisions are made; the United Kingdom itself is fully on track to meet the economic convergence criteria; and, we believe these are sensible policies in their own right.

But we also believe that macroeconomic conditions are necessary, but not sufficient, for the success of monetary union. In particular, we share the concerns already expressed by Mr. Schoenberg and others about the level of unemployment and the lack of flexibility in labor markets in the union. We share the Fund staff's concern that not nearly enough is being done by governments to free up labor

markets and reduce the level of unemployment, which seems to us one, if not the main, economic challenge facing the members of the EU.

Mr. Schoenberg and Mr. Fernández have underscored the importance of labor markets in the union, given the constraints on national fiscal policies and the absence of labor mobility and of central fiscal transfers. I think all that suggests a heavy burden on labor markets and, indeed, goods markets as well. Mr. Fernández is right to remind us of that, but I think the problems are greater in labor markets than they are in goods markets.

So far as the United Kingdom is concerned, our decision as to whether or not to participate if EMU goes ahead in 1999 will be based on our assessment of what it would mean for the United Kingdom in terms of jobs, investment, exports, and so on.

I want now just to turn to one issue which we have emphasized in recent months, and that is our concerns about the issues of the countries that are in the monetary union and those that are outside. Stage 3, of course, will involve some of each. Also, when new members join the European Union, presumably they will initially be outside the monetary union.

It seems to us that there are some quite important challenges here. One, of course, is to maintain and reinforce a single market, but another is to ensure that countries that are not in the initial group of those forming a monetary union should not find it progressively more difficult to join the Euro area. Some people have suggested some kind of old style exchange rate mechanism. The past few years have shown that such systems cannot cope with major market stress and turbulence.

Of course, a new ERM would have to embrace some countries which are at the start, by definition, nonconvergent. And certainly we would not want to see economies outside the Euro area, particularly those joining the EU, facing a tougher task in joining EMU than that faced by those in the first wave. In that context, the tight fiscal discipline which we agree will be needed in Stage 3 must be operated in a way that does not make it harder for member states to join a single currency after the first wave.

Concerning the interesting simulations in the main paper, I noted Mr. Ravasio's concern that not enough account had been taken of the benefits of EMU on interest rates. I have also heard criticisms that fiscal retrenchment in those countries where there is little scope to cut rates further is likely to have a more depressing effect on output than indicated here. In general, I find these results plausible, but of rather limited value. There are very important issues here, the extent to which fiscal consolidation can be offset—more than offset by lower interest rates, more credibility, better balance. But I am not sure that adding these kinds of numbers, which always require a very special kind of input to these models, tells us a great deal more.

The economic outlook for Europe in the next few years is also important. I agree with Mr. Schoenberg that a project as important as EMU should not stand or fall simply by an accident of cyclical fluctuations. But it will be a pity if, to demonstrate that we are good Europeans, we must always be optimistic about our forecasts of European economies.

Let me turn to the question of the Fund and surveillance in the EU. First, I welcome the collaboration between the Fund staff and the Commission, which has been evident in the preparation of this paper, and Mr. Ravasio's generally very helpful comments. I think that Fund surveillance does add value in the approach and will add value in the implementation of monetary union. There is no substitute for close informal contacts at the working level. I was pleased to hear from both the Managing Director and the Commission of the strengthening of relations, and I hope this continues.

As to the Fund's own surveillance, clearly we must address convergence issues across the European Union. We can do that in Article IV consultations; we can do it in the WEO. The Fund is obviously well placed to raise issues of spillovers from EMU to other countries. I agree that the Fund should be prepared to raise issues of possible exchange market tensions privately, as it would with other members. I go some way in agreeing with Mr. Andersen that increasing emphasis on regional surveillance as, of course, a supplement and not a replacement to country surveillance is important.

Finally, Mr. Mesaki, Mr. Fernández, and others have made the point that EMU is as much or more a political process as an economic one. I agree with that. One of the favorite remarks of my minister, Mr. Clarke, is that good economics makes for good politics. That is especially true here.

The Director of the European I Department, noting that the statute of the European Central Bank standards was modeled on that of the Bundesbank, said that the assumption underlying the model simulations was that the Euro would be as strong as the German mark, which implied that interest rates prevailing in Europe would be similar to those applicable to German-mark-denominated instruments. However, the default risk for some countries could rise after EMU, as governments would no longer have recourse to financing from their own central banks. Because of that risk, individual countries would continue to face interest rate premiums, but the premiums would be smaller than at present, as all participating countries would face the same inflation and exchange rate risks.

The discussion of monetary policy in the paper was coordinated with the WEO, the Director continued. Monetary policy had a role in reducing the recessionary consequences of fiscal adjustment. Risk premiums were likely to decline for countries that were successfully pursuing fiscal consolidation as the market perception of those countries improved. There could also be some room for monetary easing in Germany, provided fiscal adjustment continued. The Bundesbank might be reluctant to allow monetary easing in light of the rapid M3 growth in January. Nevertheless, if this growth spurt turned out to be temporary—which it could, considering it had followed a period of very slow growth—some further easing could be considered.

Ms. Lissakers expressed the view that the individual European Article IV consultations had not contained a strong consistent message about the need to maintain a forward-looking monetary policy that anticipated fiscal drag resulting from deficit reduction measures.

Mr. Autheman remarked that, in the case of his country, the Fund staff had been explicit in its advice that faster fiscal consolidation would go a significant way toward allowing a more expansionary monetary policy. The message had been forcefully conveyed to European countries during the recent period and, to some extent, had been heeded.

The Director of the European I Department confirmed that the policy message, described by Mr. Autheman, was contained in the WEO and had been repeated in various forums. For example, in the Italian consultation, the emphasis had been on the acceleration of the fiscal package, which would permit, with improvement in inflation and a strengthening in the exchange rate, an easing of monetary policy.

Mr. Schoenberg, commenting on the possibility of interest cuts in Europe, emphasized that the Bundesbank should not be expected to lower interest rates in order to compensate for fiscal adjustment in other countries.

The Director of the European I Department remarked that for countries with premiums, accelerated fiscal consolidation would induce an automatic easing in the money market as the risk premiums declined. For countries without premiums, fiscal consolidation was not likely to produce significant effects on their own interest rates. The room for interest rate reductions in those countries would depend on Germany's monetary policy actions. In turn, those actions would be guided by the Bundesbank's considerations. Provided the German Government took measures necessary to meet the 3 percent deficit requirement, and provided the inflation outlook remained favorable, the Bundesbank's flexibility would increase and interest rates could be reduced.

Mr. Fernández asked the staff what role, if any, a centralized fiscal policy was expected to play under EMU. In the absence of a centralized fiscal function, it would be difficult to deal with economic shocks affecting individual member countries, because the role of other policy instruments would be significantly constrained. The requirement to meet the deficit targets would reduce the room for maneuver of national fiscal policies. Similarly, national exchange rate policies would no longer be available to national governments under a common currency.

The Director of the European I Department expressed the view that the provisions of Article 3 of the Maastricht Treaty applied only in very specific circumstances. The Article, taken from the Treaty of Rome, stated that the Community could help a member state facing a serious difficulty. But at Maastricht it was also agreed—and was reflected in the Article containing the no bailout clause—that the Community would not take over a member's public finance problems.

The question of fiscal policy instruments in EMU had been discussed extensively in academic literature, the Director continued. National governments in Europe were much larger in terms of their budget than local governments in the United States. In that sense, the member governments would retain some fiscal capacity to respond to shocks affecting only one region. It was therefore important to regard the 3 percent deficit criterion as a ceiling, whereas the



norm would be a much smaller deficit or perhaps even a balanced budget. With such practice the governments would retain sufficient flexibility to respond to shocks.

Mr. Fernández remarked that a monetary union without a central fiscal function would not allow effective stabilization. That was a legitimate problem requiring attention of the European Union.

Mr. Schoenberg expressed the view that the precondition for a central fiscal function would be political union—which, in Europe, was still some way off.

The Director of the European I Department emphasized the importance of the market reactions to the convergence process, and their influence on the process itself. Reducing any lingering uncertainties by clarifying the interpretation of the convergence criteria interpretation while maintaining harmonious relations among member countries would minimize the risk of market turbulence. Any adverse market reaction could complicate the fiscal adjustment efforts.

The staff representative from the European I Department explained that, in the model simulations, the primary structural balances in the baseline scenarios had been held at their 1995 levels. That meant that the scenarios had not taken account of measures taken in the context of 1996 budgets or later. To calculate the extent of fiscal adjustment required in 1997, the model simulations took into account the path of economic growth projected in the baseline scenario for 1996 and 1997, as well as the path of interest rates expected in Germany.

Mr. Han made the following statement:

First, I would like to welcome this timely discussion on the EMU issue. The staff's helpful deliberations on this complex issue deserve commendation, and I am also grateful to Mr. Ravasio for giving the latest information from the EU Commission. In view of the prospective significant impact from EMU emergence, I would add my observations on the general policy framework of the EMU and the role of the Fund.

As regards the general policy framework of EMU, the EMU issue is a matter of convergence of economic fundamentals, and policy action and coordination in support of this. As the theory of monetary union shows, the more convergence and flexibility in the labor market, the less cost for integration. To secure less costly integration, a mechanism to effectively ensure the convergence of economic fundamentals, and subsequently prevent the widening of asymmetries in case of unexpected shocks within Europe, is of crucial importance. However, the review of the EMU process seems to leave us with the impression that the mechanism to fundamentally address the asymmetry issue is far from being established. In the absence of such a mechanism, the EMU operation, based on a single monetary policy and national fiscal policies, will still be at risk. On this point, I also share Mr. Shaalan's concern over the hasty efforts in moving toward EMU at the expense of softening the criteria. Such actions may be dangerous in view of the recent slowing down of the European economy.

Secondly, the labor market issue, which is appropriately analyzed in the staff paper for the possible consequences on monetary union, deserves emphasis.

Although there is a trade-off between unemployment and inflation and, therefore, unemployment is not included in the criteria, the recent experience of industrial countries shows that unemployment still rises despite an economic upswing. As is widely concurred, the structural rigidities in the labor market are at the core of the problem and deeply linked to the fiscal deficit and inflation. Furthermore, inflexibility will also impede the significant labor mobility required by the monetary union. In this connection, we see the merit of the staff's position that the efforts to fundamentally address the labor market issue needs to be placed on the agenda.

On the role of the Fund, we are pleased to see that the Fund has made progress in surveillance over the European issues and such endeavors should be encouraged. As the Fund is endowed with a surveillance function, the EMU issues, which will have important bearings on future international exchange rate arrangements, deserve the Fund's concentration. To reach this goal, the Fund still has much to do. First, we support the strengthened monitoring and surveillance over the EMU issues and hope such practice will have input on the EMU process. Therefore, I would like to encourage management to seek an appropriate way to communicate with EMU institutions and would be pleased to be informed about the recent cooperation between the Fund and EMU institutions. As for the format of surveillance, the specific studies on important issues are welcome, and I see the merit for basing these efforts on existing studies of European institutions to avoid repetition of efforts. Furthermore, more focus on EMU issues in the WEO and International Capital Markets is welcome. Secondly, I would like to encourage the staff to study the impact of the EMU on the international monetary system, other regional economies, and developing countries.

Mr. O'Loughlin made the following statement:

Mr. Grilli has admirably outlined the views of EU members on a range of issues connected with EMU. I can, therefore, confine my comments to just a few of the issues raised in the staff paper.

In the area of economic policy:

The staff is right to emphasize the need to bring fiscal deficits within the Maastricht parameter, despite the current economic slowdown. Any perceived weakening in adjustment effort must add to questions about ability to launch the single currency project as planned;

This consideration puts a heavy burden on those countries whose participation is perceived by financial markets as most critical to formation of a monetary union. Providing the earliest possible conviction to the markets that they will achieve all the various Maastricht parameters may well be the key contribution which those countries can make to a smooth transition to EMU;

On the relative merits of faster or slower adjustment, Irish experience suggests that strong adjustment—sustained—does pay dividends. But I have to acknowledge that this is a counsel to perfection; substantial adjustment is not easily implemented;

On the question of priorities within national policies to limit financial market uncertainties, there is a strong case—based on prevailing concerns about high unemployment in Europe—for concentrating fiscal consolidation on the expenditure side of budgets, desirably in a manner which might enhance incentives but not diminish infrastructural development which contributes to sustainable economic growth.

That brings me to a point about the simulations which deserves special emphasis, given that the public often feels that fiscal consolidation damages employment. The simulations, despite differing assumptions, offer one message in common: the longer-run level of economic activity—and, I infer, of employment—is improved by fiscal consolidation. If my inference is accurate the findings accord with the views of my Irish and Canadian authorities, and would deserve highlighting. This is not to gainsay the need for structural reform—Europe's unemployment will not be resolved within an acceptable timespan by economic growth alone.

Now, a few comments in relation to the EMU process:

First, on the question whether there is need for tighter surveillance of fiscal policies in Stage 3. Perhaps all countries, and not those in the EU alone, should consider the wisdom of aiming for a fiscal balance which will permit the automatic stabilizers to work to the full in "bad" times without engendering worry that debt ratios will develop upward momentum?

Second, we should not, I think, assume that there is serious "room for manoeuvre" on the interpretation of the Maastricht criteria. As Director-General Ravasio puts it, that would "run counter to both the letter and the spirit of the Treaty;" and it could well have implications for the sustainability of the venture itself. As "outsiders looking in" so to speak, my Canadian authorities would also favor establishing monetary union with a smaller group of countries that clearly meet all the criteria, as opposed to weakening the criteria or altering the existing timetable;

Third, on the question of possible arrangements between the single currency once established and other EU currencies, my Canadian authorities suggest establishing a fixed exchange rate band, which might be narrowed over time as convergence improves. This could support the further deepening of the "Single Market" to the benefit of all, and provide a framework for later entry into Stage 3 for those not initially participating. In this context my Canadian authorities stress that, as Europe moves towards a single currency, cross-border labor mobility must be increased in order to facilitate adjustment to asymmetric shocks. They would, of course, acknowledge that other arrangements may be necessary to address the situation of those who may prefer to remain outside the single-currency frame!

On the role of the Fund, we would tend to agree that the staff could contribute best in the EMU context by offering independent research in areas which may not be directly considered by the Commission or the EMI. My Canadian authorities consider that there is a need to examine issues related to the impact of

monetary union on non-EU countries, both in and outside Europe; and its potential impact on broader, global, issues including trade and trade-related policies, external imbalances and financial instability.

On the Irish policy stance, I should not conclude without indicating that Irish policy remains focused on meeting the requirements for participation in EMU which were established in the Maastricht Treaty—so that Ireland will be positioned to enter into the planned monetary union from its inception.

Mr. Mozhin made the following statement:

We have before us a thoughtful and informative paper, and my main conclusion is that the unique project of economic and monetary union in Europe is all about individual countries' commitments, which will be severely tested at every stage of the EMU process. For the majority of the EU member states, compliance with the convergence criteria by 1997 seems to be achievable, if only the interpretation of these convergence criteria provided in the staff paper is correct. Therefore, the basic question is not whether the EU member states can make it, but rather how strongly they want to make it, or how strong their commitments are. Perhaps, the recent slowdown in the growth performance all across the EU has been quite timely in the sense that by making the task of compliance with the convergence criteria somewhat more difficult, it provides for an early test of will.

As I certainly cannot compete with my European colleagues in terms of the depth of understanding of the EMU process, I will offer only several brief observations.

Let me, first, comment on the most delicate issue of possible trade-offs as they are formulated in the staff paper. One can hardly question the soundness of the prevailing view which, according to the staff, is that "the EU's goal has become, at present, one of maximizing the number of participating countries subject to constraints on timing and qualification criteria." However, the obvious question that comes to mind is: What is going to happen if by the time of the decision on Stage 3, it turns out that only a few countries were able to satisfy the qualification criteria? At the moment, there is no answer to this question and, perhaps, there should not be, as in this worst case scenario the ultimate choice between postponing the whole project and relaxing the qualification criteria would be most traumatic. The danger here is that if too many countries become clearly unable to qualify too early in the process, there could be strong pressure for a premature answer to this question.

Whatever the risks and uncertainties, I have the impression that there is a growing expectation that Stage 3 will not be postponed. Perhaps, one sign of this growing expectation is a growing concern about how to make sure that Stage 3 participating member states will continue to behave in a responsible way, especially in the fiscal policy area. In that respect, the German authorities' proposal for tighter Stage 3 surveillance of fiscal policy, including the possibility of sanctions on those who do not comply seems to be quite timely. At the same time, I wonder whether under the conditions of the EMU an inappropriate fiscal policy would not be

severely penalized by the financial markets. It is indicated in the staff paper that for some countries in Stage 3 interest rate premiums for sovereign risk could rise, as they will no longer have the option of reducing debt through inflation. In other words, one may hope that in Stage 3 the financial markets will make inappropriate fiscal policy increasingly costly.

Finally, Mr Chairman, I have two factual questions.

First, I wonder whether there is any established entrance procedure for those countries that will not participate in Stage 3 from the very beginning. Will they join as soon as they are able to comply with the qualification criteria, or will there be some sort of waiting period?

Second, the staff paper does not mention what the arrangements for international reserves are. Will Stage 3 participating member states retain their international reserves or, perhaps, some portion of them, or will those be pooled and put under the control of the ECB?

Mr. Himani made the following statement:

At the outset, I would like to compliment the staff on an interesting and very readable set of papers. I also welcome the very useful statement by Mr. Ravasio.

Monetary union in Europe is arguably one of the most ambitious undertakings in monetary history. Therefore, it should be no surprise that this undertaking is fraught with a number of difficulties.

Regarding economic policies, the current uncertainties in the economic outlook in Europe has certainly complicated the task of economic convergence. One can argue in favor of a slower pace of adjustment in certain countries. However, it is obvious that the credibility of measures is key to the success of the adjustment process, and it is not immediately apparent how credibility can be sufficiently enhanced in a slower adjustment scenario.

Regarding the EMU process itself, I will make two comments:

First, the paper makes an interesting presentation of possible trade-offs between a timely start to Stage 3, the strictness of eligibility criteria, and the number of countries initially qualifying to participate. Mr. Kaeser has made potent arguments in favor of strict interpretation of the Maastricht criteria. However, one must also recognize that some of the relevant questions in this respect are somewhat academic as the final decisions will likely be influenced to significant extent by political considerations.

Second, the circumstances of EU countries not participating in Stage 3 will likely be such as to require different approaches to their exchange rate arrangements. This being said, I wonder if the staff could comment on whether making the Euro legal tender, along side national currencies in countries not

participating in Stage 3, might help enhance credibility and facilitate integration into the monetary union.

Turning to the role of the Fund, I have three comments:

First, there is certainly overlap between Fund and EU surveillance. Such overlap will facilitate focusing only on those areas where Fund and EU views differ or converge. Continued monitoring and surveillance by the Fund, combined with a continuous dialogue with the EU, is central to facilitate the role of the Fund in trying to signal early warning regarding possible market tensions and recommending policies to address them.

Second, I see merit in staff's suggestions regarding the scope and format of future Board discussions on EU issues. However, given our role as a monetary institution, it would seem reasonable to combine as many of the discussions of nonmonetary issues as possible.

Third, a critical contribution by the Fund would be careful examination of the impact of the EMU process on countries outside the EU and the international financial system as a whole. This is particularly relevant for countries with close ties to the EU, including the CFA franc countries, the transition economies of Eastern Europe, and economies of the Mediterranean basin. I look forward to future discussions on this topic, and here I welcome the Chairman's suggestions at the beginning of today's meeting.

Mr. Barro Chambrier made the following statement:

As stated on previous occasions, I believe that the convergence criteria set out in the Maastricht Treaty provide a useful framework, in order to encourage financial discipline and economic convergence among European countries. The fulfillment of the conditions are necessary to enter into the final stage of monetary union. Like Mr. Mesaki, we are concerned by the potential gains that could bring EMU in terms of more stability in the international monetary system.

I agree with previous speakers that the approach to EMU is a gradual one and for which, success hinges on commitment of every member state. However, I note also from the staff paper the difficult challenges that many countries will have to face over the next few years. These challenges, which are complicated by the current economic slowdown in the EU, present also the risk of increasing the uncertainties about the outlook for economic policies for the EMU.

I welcome the important steps already achieved in Stage 2. However, to achieve convergence criteria set in the Maastricht Treaty, close cooperation among the monetary authorities will be imperative, but also the pursuit of appropriate supporting macroeconomic policies.

Since most of the issues have been broadly addressed by previous speakers, I will be brief and focus my remarks on a few points for emphasis.

With regard to the role of economic policies, given the diversity of economic conditions and policy priorities, it is not surprising that economic and financial performance has also been different in member countries, as evidenced by the recent developments. In view of the common targets that member countries are endeavoring to achieve to start the Stage 3 of EMU, there is no doubt that the pace of adjustment represents a key element to the success toward this process. In light of the simulations provided in the staff report, it is important for countries experiencing high deficits to accelerate the speed of their fiscal adjustment, so as to reduce their deficits and debts/GDP ratio to sustainable levels. While appropriate fiscal policies may be essential to permit a gradual easing of the short term interest rates, structural policies particularly, on the labor market reform, are indispensable to achieve successfully the goal.

The achievement of the convergence to the Maastricht criteria, as clearly indicated in the paper is not an easy task. Indeed, despite the determination shown since then by the member countries in this area, the staff paper states that some countries could meet the convergence criteria, while other may not be able to achieve the convergence criteria and therefore, would not be able to qualify for Stage 3. It seems to us that the weak convergers should be provided more time to meet the requirements for entry into Stage 3 of EMU.

On the role of the Fund, in view of the EU economic developments and prospects, I welcome the fact that close collaboration between the Fund staff and the EU institutions is underway. I also consider that the surveillance should be strengthened, in the context of the Article IV consultation as well as of WEO.

Finally, as already stated by previous speakers, I look forward to discussing the papers on the impact of EMU on other monetary system, such as the CFA zone, as well as on countries in transition.

Mrs. Guti made the following statement:

Adjustment for an individual country is hard enough; collective adjustment—which is what movement toward the EMU is all about—could not be less difficult. So it is not surprising that there will be slippages along the way. There has been much progress in containing inflation, although the less wealthy countries (Greece, Spain, and Portugal) seem to be having a more difficult time in the process; however, the results on the fiscal front have been less satisfactory. The latter tends to underscore the underlying tension between economic objectives and political reality. Experience suggests that there is a lesser degree of difficulty in implementing restrictive monetary policy to combat inflation, which is somewhat removed from the political arena; this is not so with fiscal policy; hence, the slower pace of adjustment. The framers of the EMU have been astute in that the Maastricht Treaty is sufficiently ambiguous in certain areas to allow flexibility while remaining focused on progressive movement toward the goal of monetary integration. A faster speed of adjustment might be desirable; but it could lead to political tensions that might undermine the overall objective. This takes added credence at a time when unemployment is at such a high level in Europe and countries seem to be having a difficult time putting the economy on a high growth

path. In this connection, the easing of monetary conditions in some countries might improve growth prospects. But the authorities have to be careful not to create inflationary pressures.

Having said this, the fact should not be lost that although the issue is monetary union, the key to success hinges on fiscal policy. This is a matter not only for the bigger countries, or the ones that are able to qualify under existing convergence criteria. Market tensions could also arise if fiscal discipline is seen to be weak in countries that have not fully qualified. The bottom line is that a stability-oriented single monetary policy in Europe will require strong surveillance of fiscal policies. It should be added, in this connection, that the process of fiscal consolidation has to take into account structural reform. In this regard, the staff paper has correctly identified the need for action to improve labor market flexibility.

As for the role of the Fund, there is no question that its surveillance of EU countries must continue, even though this is going on in the Union itself. The Fund needs to be more forward looking, rather than merely react to situations. The impact of EU policies on the global economy should be stressed, paying attention to the effect on developing countries with historically strong economic links to Europe.

Regarding the format for Board discussions, we need to be flexible. However, it would help to deal with related topics at the same time. There is one question: if there is a common monetary policy which requires conformity to some fiscal norm on the part of all participants, would not individual Article IV consultations lead to an overlap?

Mr. Costa made the following statement:

The staff papers leave aside, correctly in my view, the economic case for EMU since the determining factor for a monetary union is political rather than economic. Nonetheless, it is clear that there is a close link between these two aspects and that, in the end, the markets will have the last word.

I will limit myself to a few comments on: first, the need to maintain strict adherence to the Maastricht criteria already agreed upon; second, the need for strong fundamentals at the time of the announcement of Stage 3, the need to deepen structural reforms.

I side with those that believe that a postponement of EMU or a relaxation of the Maastricht criteria would be counterproductive. As noted by Mr. Schoenberg and others, the fiscal deficit target should be met irrespective of the EMU deadlines, otherwise present uncertainties would be heightened, adversely impacting business confidence, investment and growth prospects.

A frequently heard objection to EMU is that the rush to meet the fiscal targets will bring about a recession and even social turmoil, derailing the whole process of European integration. The staff papers make clear that notwithstanding



conventional views, a credible fiscal adjustment has the potential to enhance growth. It is worth underscoring that this can occur even in the case where the adjustment effort is substantial and its effects not be unduly lagged if the adjustment is credible and improves market sentiment. Moreover, the improved chances of a successful monetary union will reinforce confidence, helping to dispel the uncertainties that may be presently impinging on the growth prospects of Europe at large.

Strict adherence to the Maastricht criteria will also lend credibility to the ECB. The sooner this credibility is gained the better the chances to move towards a more balanced policy mix, when needed. It is difficult to conceive a successful beginning of EMU if it were to be preceded by turmoil in financial markets. All efforts should be made, therefore, to achieve strong fundamentals for the European economies at large and for those that will take part of Stage 3 in particular. This, rather than merely stronger provisions concerning symmetric intervention commitments will be the best assurance for a successful beginning of EMU.

Together with strong fundamentals I fully share the emphasis given by previous speakers to structural reforms encompassing subsidies, distortionary taxation, overly generous welfare systems and excessively large state sectors. European governments face a real challenge in trying to revamp the so-called "European Model" while maintaining a high level of social protection. Success in this field would establish a very encouraging example for other countries to follow.

Finally, the "European Model" contains important differences in emphasis with the Fund regarding policy advice in labor markets. More emphasis is given in the EU approach to factors such as training, mobility and employment services, as compared with flexibilization of wages in general and minimum wages in particular, which seems to be the preferred Fund approach. The range of policy options, however, should in my view remain sufficiently broad including, for example, as the linking unemployment benefits to education and training programs, as it was pointed out in our recent seminar on unemployment and taxation.

In concluding I would like to pose a question to the staff in line with the one posed by Mr. Mozhin: Who will appropriate the seigniorage in Stage 3 and how will it be distributed among participant countries?

We are confident that European governments will take full advantage of this historical opportunity to advance peace and prosperity for their continent and the world at large and that the Fund will be able to play a useful policy advice role to facilitate the convergence process in this most ambitious project.

The staff representative from the Office in Europe replied that there was a provision regarding seigniorage in the statutes of the European Central Bank. There were rules for the original contribution to the Bank's capital by each national central bank, and it was on that basis that profits would be distributed.

Mr. Kiekens added that the capital in the European Central Bank would be determined according to two criteria: the size of population and GDP, each element accounting for

50 percent in the calculation. Thus, allocation of seigniorage would also depend on the two criteria.

The staff representative from the European I Department, addressing the question of the procedures for countries not participating initially in Stage 3, explained that the Treaty specified that their status—referred to as “countries with a derogation”—would be considered at least once every two years, although it could be considered at a shorter interval if the country concerned so wished.

Ms. Lissakers, noting the high quality of the staff paper and the complimentary comments made by Mr. Ravasio, suggested that the paper be considered for publication.

The Chairman expressed support for Ms. Lissakers’s proposal, remarking that additional editing would be required to reflect Directors’ suggestions and comments.

Mr. Kiekens recommended that the idea of publication be discussed with representatives of the European Commission and of the European Monetary Institute. It would be fair to do so as the paper was based, at least partly, on the information they had provided.

The Chairman agreed that such consultation would be desirable to ensure that the policies and positions of the European Commission and the Institute were characterized accurately in the paper.

Messrs. Andersen, Evans, Grilli, and Schoenberg also supported the idea of consulting European institutions prior to publication.

Mr. Evans thought it important to avoid taking steps that would complicate the future relationship between the Fund and European institutions and governments.

Mr. Schoenberg said that he supported careful editing of the paper to ensure that it did not lead to adverse market reactions.

Mr. Fernández, expressing reservations about the paper’s publication, asked the staff how the public was expected to benefit from the main thesis of the paper—clarification of the convergence criteria—and whether such clarification was expected to help prevent market turbulence.

The Director of the European I Department pointed out that there appeared to be uncertainty with respect to the interpretation of some of the criteria. If the debt criterion were applied strictly, Belgium, the Netherlands, and Austria could not become members of Euro area. Another criterion was membership in the ERM. Was ERM membership essential for joining EMU? Would the country that was not part of the ERM be excluded from EMU despite its claims that it had the option to join? The staff believed that some clarification of those aspects could help reduce possible market speculation.

Mr. Cailleteau said that he would prefer to relay the information related to criteria interpretation to his authorities directly, rather than by way of a published paper.

Mr. Kiekens indicated that his Belgian authorities were quite confident that the interpretation of the debt criterion was not a major issue. Hence, he would be somewhat concerned were the Fund to state publicly that the interpretation of some of the criteria was a major issue requiring clarification. That, in fact, could create problems, instead of avoiding them.

The Chairman expressed hope that such concerns could be allayed when the EU institutions were consulted.

The Chairman made the following concluding remarks:

Executive Directors welcomed the opportunity to discuss in a seminar setting the progress toward Economic and Monetary Union (EMU) among the EU members. They emphasized the strong interest of the Fund—and of the global community—in a successful process of economic and monetary integration in Europe. Directors noted that, with less than three years remaining until the prospective start of the third and final stage of the EMU, there was still a wide range of issues, relating both to the management of the EMU process as a whole and to the policies being followed by EU member states in preparing for monetary union, that were of importance for Fund surveillance.

Directors underlined the need to see EMU as part of a broader political process. They recognized the central role that convergence requirements under the Maastricht Treaty had played in disciplining macroeconomic policies in many EU countries. While it was clearly desirable that the process should proceed within the time frame envisaged in the Treaty, Directors recognized that the economic slowdown in Europe was making more difficult the task of satisfying the Treaty's convergence requirements, particularly in the fiscal area.

Directors also emphasized that the fiscal consolidation efforts being undertaken by EU countries in preparation for EMU were desirable in their own right. Several noted that compliance with the Maastricht Treaty's reference value for the general government deficit of 3 percent of GDP was only a step—although an important one for many countries—toward achieving a satisfactory position for the public finances. Indeed, there was now wider understanding that the 3 percent level shall be regarded as a ceiling: a number of Directors welcomed the initiative to establish a Stability Pact incorporating a much lower "norm" for fiscal deficit. While all agreed on the need to reduce deficits, a central question was how fast this should be done. Some Directors pointed to the possible risks of stronger and generalized fiscal consolidation at a time when economic growth was weakening and output gaps remained large in the wake of the 1992/93 recession.

With respect to the higher deficit countries, some speakers referred to the staff scenarios which showed that fiscal consolidation could still yield significant medium-term benefits under a slower and more gradual adjustment path than that required to meet the Treaty's convergence requirements in 1997, if the commitment to consolidation could be made credible to the markets. Most Directors, however, stressed the advantages of a bold approach to consolidation: they considered that these countries could gain credibility and achieve the full

medium-term benefits of consolidation by substantial early progress in adjustment. They also pointed out that the short-term demand effects of fiscal consolidation could—according to the staff scenarios—be fairly quickly offset by the beneficial effects of lower interest rate premiums.

Turning to the countries with intermediate adjustment needs, and assuming that the economic growth in the EU recovered during 1996, many Directors thought that it would be appropriate to take measures to reduce the general government deficit below 3 percent in 1997. However, if the present slowdown should prove more protracted than expected, some Directors argued that it could be counterproductive to introduce yet further consolidation measures. Other Directors stressed that any short-term cost of fiscal adjustment should be weighed against the benefits of EMU, and they pointed to the dangers that the entire process might be put at risk if a sufficient number of countries were not ready to participate at the beginning of 1999.

Concerning the role for monetary policy in supporting the adjustment process in high-deficit countries, Directors thought that credible fiscal consolidation policies would lead to declines in interest rate premiums, but that the markets would be unlikely to tolerate efforts to force interest rate reductions. However, with the economic slowing particularly concentrated in the “core” economies of the ERM, which generally had less burdensome fiscal adjustment needs, a number of Directors considered that there could be a case for further reduction of official interest rates in these countries, which would allow additional easing of monetary conditions also in the higher-deficit countries.

All Directors stressed that more flexible labor markets in Europe would be essential if the benefits of monetary union were to be fully realized, but there were divergences of view about the timing and importance of labor market reforms. Some noted that deep-rooted labor market problems could create credibility problems in the transition to monetary union, and called for early action. A number of other Directors emphasized, however, that one should not overestimate the speed with which reforms could improve labor market conditions and operation. Some of these also cautioned that labor market reforms should be implemented in a manner that would avoid political and social disruption.

Directors noted that the scenarios reported in the staff paper suggested that the fiscal consolidation process in the EU would probably have little effect overall on countries outside the EU. Some observed that the effects could be more significant on countries with particularly close ties to the EU. A number of Directors called for the Fund to pay more attention to the economic impact of European integration on the rest of the world.

Turning to the process as a whole, Directors observed that attention was focusing increasingly on the assessment planned for early 1998 of which countries would be ready to enter Stage 3 on January 1, 1999. They noted that, in reaching this assessment, there would inevitably be tensions between the two goals of achieving as wide as possible participation of countries and applying strict qualification criteria.

Directors generally thought that strict pre-conditions were appropriate for participation in the monetary union. Many thought that any loosening of the qualification criteria could have adverse effects on the initial credibility of the European Central Bank. Given the important progress already achieved with respect to convergence in inflation and interest rate differentials, it was clear that satisfying the criterion for the government finances was the key challenge.

Some Directors thought that the convergence criteria for government debt and exchange rate stability were less critical to assessing a country's readiness for Stage 3. Others recalled, however, that the convergence criteria constituted a coherent and integrated package designed to demonstrate a high degree of convergence before Stage 3 began. They stressed, therefore, that the debt and exchange rate requirements were an essential part of the judgment that would be made in early 1998.

Directors generally thought that an important challenge in the transition to Stage 3 would be to prevent the emergence of market tensions, and strong convergence policy in the EU member states would be essential for this. Most Directors also thought that early agreement on a number of key points could help build confidence in the EMU process and reduce potential uncertainties concerning the status of individual countries. In particular, these Directors thought that, after the decision to move forward with Stage 3 had been made, strong and symmetric intervention commitments to support the exchange rates of countries selected to participate would help to avoid speculation on the exchange rate at which currencies would be locked. Many Directors noted that early agreement on a Stability Pact to guide surveillance of fiscal policies once monetary union had commenced and on exchange rate relations between the Euro and the currencies of EU countries not participating initially in the single monetary policy could impart additional confidence to the EMU process.

Turning to the role of the Fund, Directors noted that the perspectives of the surveillance by the Fund and EU institutions differed somewhat but were complementary, with the advice of the Fund provided in the global context of the operation of the international monetary system and that of the EU focusing more narrowly on economic and monetary integration in Europe. Nevertheless, the advice given by the EU and the Fund to their common members had been broadly consistent and mutually reinforcing. There had been differences of emphasis in labor market strategies, but these appeared to be narrowing, and both the Fund and the EU advice stood to gain from understanding the perspective of the other.

Directors underlined the importance of intensive Fund surveillance in view of the major challenges over the coming years in fostering a successful transition to monetary union in Europe. They emphasized that the Fund should be particularly vigilant in identifying potential market tensions in the uncertain period up to the beginning of Stage 3. In carrying out this task, Directors encouraged continued, and indeed closer, contacts between the staffs of the Fund and the EU institutions. Directors also noted that the Fund would increasingly need to focus on the policy issues that will be faced in Stage 3. It would also need to consider, in conjunction

with the EU countries, how relations between the Fund and EU members will be affected by the establishment of the European Central Bank.

Directors thought that it was appropriate that, in presenting its work on European Union issues to the Executive Board, the staff should continue to focus on specific topics or sets of topics as it had done for today's seminar. They looked forward to future staff papers dealing with progress toward monetary union as well as those that might deal with other areas such as trade and trade-related policies and the intensifying relations with nonmember countries in eastern Europe and the Mediterranean region.

Directors also discussed the issue of publication of the staff paper. In light of sensitive issues addressed in the paper, the Directors agreed that the Fund should consult with the EU institutions, that it should take into account the comments and concerns expressed by Executive Directors in today's discussion and that particular care should be taken in eliminating from the text for publication of market-sensitive material, while keeping the substance and analytical value of the staff study.

REINHARD H. MUNZBERG  
Secretary