

DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

MASTER FILES
ROOM C-525

0450

SM/96/41

February 14, 1996

To: Members of the Executive Board
From: The Acting Secretary
Subject: Progress Toward EMU - Developments and Selected Issues

Attached for consideration by the Executive Directors is a paper on progress toward EMU - developments and selected issues. This subject, together with Annexes (to be circulated), is tentatively scheduled for a seminar discussion on Wednesday, March 6, 1996.

The paper on the operation of monetary policy in European economic and monetary union (SM/95/217, 8/25/95), will serve as background material for the seminar discussion.

Mr. D. McDonald (ext. 38862) is available to answer technical or factual questions relating to this paper.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

Progress Toward EMU: Developments and Selected Issues

**Prepared by the European I Department
(In collaboration with the Policy Development and Review Department,
the Research Department, and the Office in Europe)**

Approved by Massimo Russo

February 12, 1996

<u>Contents</u>	<u>Page</u>
I. Introduction	1
II. Recent Developments in the Preparations for Monetary Union	2
1. Convergence status of national economies	2
2. The start of Stage 3 and the changeover to the single currency	9
3. The policy framework for Stage 3	11
a. Monetary policy	11
b. Exchange rate relations with non-participating EU currencies	13
c. Policy surveillance in Stage 3	14
III. Policy Issues in the Transition	16
1. National economic policies	17
a. Fiscal policy	17
b. Exchange rate and monetary policy	21
c. Labor market policy	22
2. Management of the EMU process	24
IV. Concluding Remarks	27
1. The role of economic policies	28
2. The design and evolution of the EMU process	29
3. The role of the Fund	30
V. Topics for Discussion	30

	<u>Contents</u>	<u>Page</u>
Boxes		
1.	Convergence Requirements of the Maastricht Treaty	3
2.	Surveillance of Economic Policies by European Union Institutions	4
3.	Proposal of the German Authorities for the Surveillance of Fiscal Policies in Stage 3	15
Charts		
1.	Inflation in the EU	4a
2.	Long-Term Government Bond Yields in the EU	4b
3.	European Union: Cumulative Changes in General Government Balance, Structural Balance, and Gross Debt	4c
4.	ERM Currencies: Deviations from Central Rates Against the Deutsche Mark	8a
5.	Non-ERM Currencies: Deviations from Average Rates Against the Deutsche Mark	8b
6.	General Government Deficit and Long-Term Interest Rate	18a
7.	Higher Deficit Countries: Profile of Fiscal Adjustment and Assumed Credibility Gains in Scenarios A and C	18b
Tables		
1.	European Union: Consumer Prices	5
2.	European Union: Long-term Government Bond Yields	6
3.	European Union: Government Budgetary Positions	7
4.	Fiscal Convergence Scenarios: Deviations from Baseline	19

I. Introduction

The Executive Board has had a number of recent opportunities to discuss key aspects of the strategy to achieve economic and monetary union (EMU) in Europe. WEO papers have analyzed progress in macroeconomic convergence, and Board seminars in March and June 1994 provided opportunities to discuss the ERM and surveillance by EU institutions. ^{1/} However, the last comprehensive discussion of EMU was in late 1992. ^{2/} Since that time, there have been important developments in the macroeconomic environment in Europe. Notably, the process of preparing national economies for EMU suffered setbacks in the recession of 1992-93, and awareness has intensified, both among policy makers and in the markets, that fixed dates, qualification criteria, and the related uncertainties as to who will participate make the EMU process vulnerable to market pressures. The increased momentum of the preparatory work over the past year has also brought some important clarifications and understandings concerning the process.

Against this background, the paper revisits a number of EU-wide issues related to EMU. ^{3/} Particular emphasis is placed on issues that are likely to affect the success of the transition to monetary union, including the smoothness of this process. There is less focus on the details of the policy framework for Stage 3 itself, and matters concerning relations between the Fund and the future European Central Bank (ECB) are not addressed. These latter issues, while important, seem less pressing given that Stage 3 is not scheduled to start for three years. The paper also does not examine aspects of economic integration in the EU that are not directly connected with the strategy to achieve monetary union, issues related to deepening economic integration with non-member countries in Europe, or economic relations with other non-member countries. ^{4/}

The structure of the paper is as follows. First, recent developments in the preparations for monetary union are reviewed. The paper then addresses key policy issues related to the transition to monetary union. The penultimate section provides some concluding observations, and the final section suggests some topics for discussion by Executive Directors.

^{1/} In March 1994, Directors discussed a paper on *Monetary Policy Issues Following the Widening of the ERM Bands* (SM/94/14, 1/27/94). In June 1994, they considered a paper on *European Union: Common Policies and Recent Institutional Developments*, (SM/94/120, 5/12/94).

^{2/} In December 1992, there was a Board seminar on *Economic and Monetary Union in Europe: Policy Issues and Implications for Fund Surveillance*, (SM/92/129, 6/26/92), with a supplement updating the material, inter alia, in light of the exchange market turmoil of the fall of 1992 (SM/92/129, Supplement 2, 12/1/92).

^{3/} Preparation of the paper benefitted from discussions with the staffs of the European Commission and the European Monetary Institute in November 1995.

^{4/} These matters were last considered in the context of the June 1994 Board seminar on the common policies and recent institutional developments of the EU, the August 1994 discussion of the *Comprehensive Trade Paper* (SM/94/192, 7/19/94) and the October 1994 Board meeting on *Regional Trade Arrangements* (SM/94/193, 7/22/94). Some of these issues have also been covered in the information notes prepared by the staff on *Recent Developments in the Policies and Institutions of the European Union* (SM/95/42, 2/21/95, and SM/95/187, 8/1/95).

II. Recent Developments in the Preparations for Monetary Union

The Treaty on European Union (the Maastricht Treaty) came into force in November 1993, with the completion of the ratification process in EU member states. Shortly thereafter, in January 1994, Stage 2 of EMU began, denoting an intensification of the preparations for economic and monetary union, through readying both the economies of member states and the institutional arrangements. Stage 2 will last until the locking of exchange rates and the commencement of the single monetary policy that will mark the beginning of Stage 3, or full monetary union.

In preparing themselves for economic and monetary union, member states are guided by the convergence criteria set out in the treaty (see Box 1). To assist with this process, the treaty provided for a marked strengthening of surveillance by EU institutions of the economic policies of member states in Stage 2 (see Box 2 and Annex 1). The first part of this section reviews where countries now stand in relation to the treaty's convergence requirements. The start of Stage 2 also saw the establishment of the European Monetary Institute (EMI), which in addition to strengthening the coordination of monetary policies, is charged with preparing for the establishment of the ECB and the single monetary policy. In this latter area, particular focus of late has been on the practical aspects of the changeover to the Euro (the name recently agreed for the single currency) and these are discussed in the second part of this section. The final part of the section covers discussions to date on the design of the policy framework for Stage 3.

1. Convergence status of national economies

At the time that a decision on eligibility for Stage 3 is to be made, both the European Commission and the EMI will present reports assessing compliance with the treaty to the Council, which for this purpose will meet in the composition of Heads of State or Government. In the meantime, both the Commission and the EMI are monitoring progress through annual convergence reports.

The latest convergence reports ^{1/} show significant progress in the areas of inflation and interest rates since the negotiation of the Maastricht Treaty in 1991, reflected in lower averages for these variables in the EU and reduced dispersion (Tables 1 and 2, Charts 1 and 2). Only four countries—Greece, Italy, Spain, and Portugal—did not satisfy the inflation criterion in 1995. Greece and Portugal continued to make progress over the past two years, but progress stalled in Spain and was reversed to some extent in Italy. These four countries and Sweden also failed to satisfy the interest rate criterion in 1995, and saw some reversal of previous improvement, except for Greece.

In the area of fiscal policy, progress has been much less satisfactory (Table 3 and Chart 3). Only three countries (Germany, Ireland, and Luxembourg) were judged to be in compliance with the treaty in the most recent excessive deficit exercise, concluded in July 1995. ^{2/} Ireland's debt ratio exceeded the treaty's reference value of 60 percent of GDP, but was deemed to be falling at a sufficiently fast pace. For the EU as a whole, the average general government deficit was higher in

^{1/} The latest reports—the Commission's third and the EMI's first—were issued in November 1995: European Commission, *Report on Convergence in the European Union in 1995* and European Monetary Institute, *Progress Towards Convergence*.

^{2/} Recently, however, it was announced that the general government deficit in Germany was 3½ percent of GDP in 1995, much larger than had been expected in the summer of 1995.

Box 1. Convergence Requirements of the Maastricht Treaty

According to the Maastricht Treaty, the readiness of EU member countries to participate in Stage 3 will be assessed on the basis of convergence criteria in the areas of public finance, inflation, long term interest rates and the exchange rate. The relevant criteria are:

- The financial position of the member's government must be sustainable, as evidenced by the country not being subject to an excessive deficit finding (see Box 2). In particular, the general government deficit should not exceed the treaty's reference value of 3 percent of GDP, or it should have declined substantially and continuously and have reached a level close to the reference value or the excess over the reference value should be temporary and exceptional. The gross debt of the general government should not exceed the reference value of 60 percent of GDP or, if it does, it should be sufficiently diminishing and approaching the reference value at a satisfactory pace.
- Consumer price inflation should not exceed that of the three best performing countries by more than 1½ percentage points and this performance should be sustainable.
- The interest rate on long-term government bonds should not exceed by more than 2 percentage points that of the three member states with lowest inflation.
- A country should have respected the "normal" fluctuation margins of the ERM for two years without severe tensions and without devaluing on its own initiative.

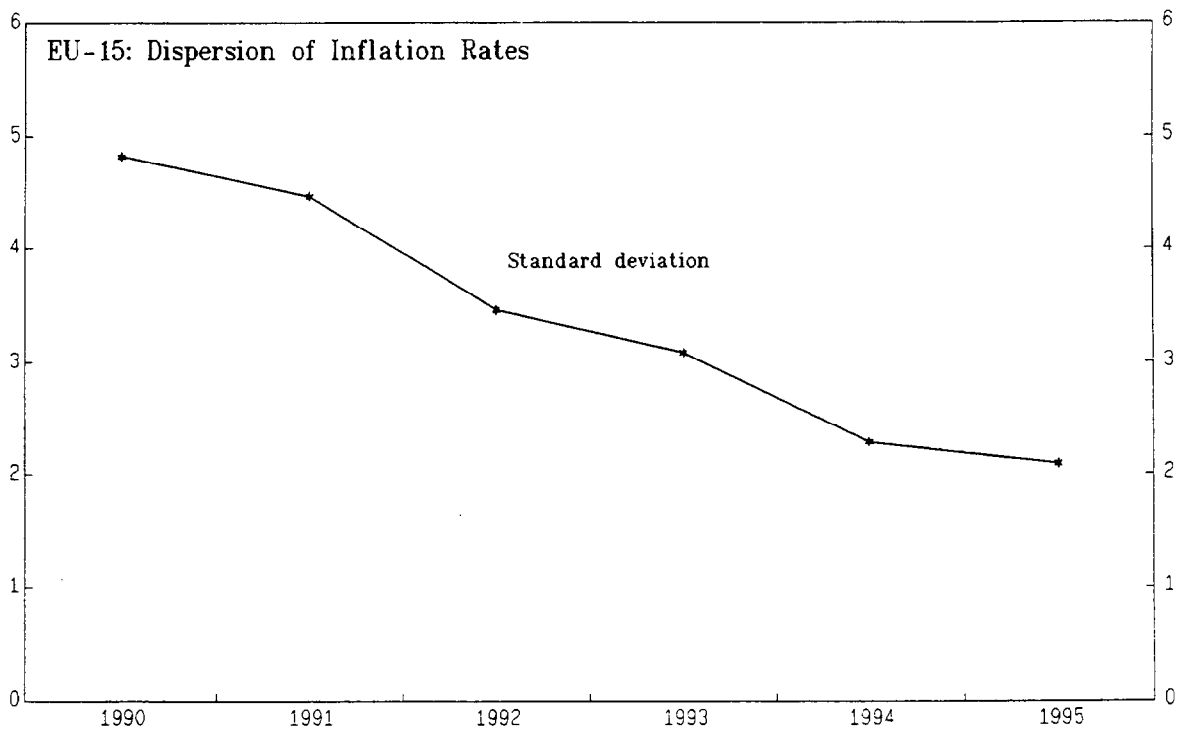
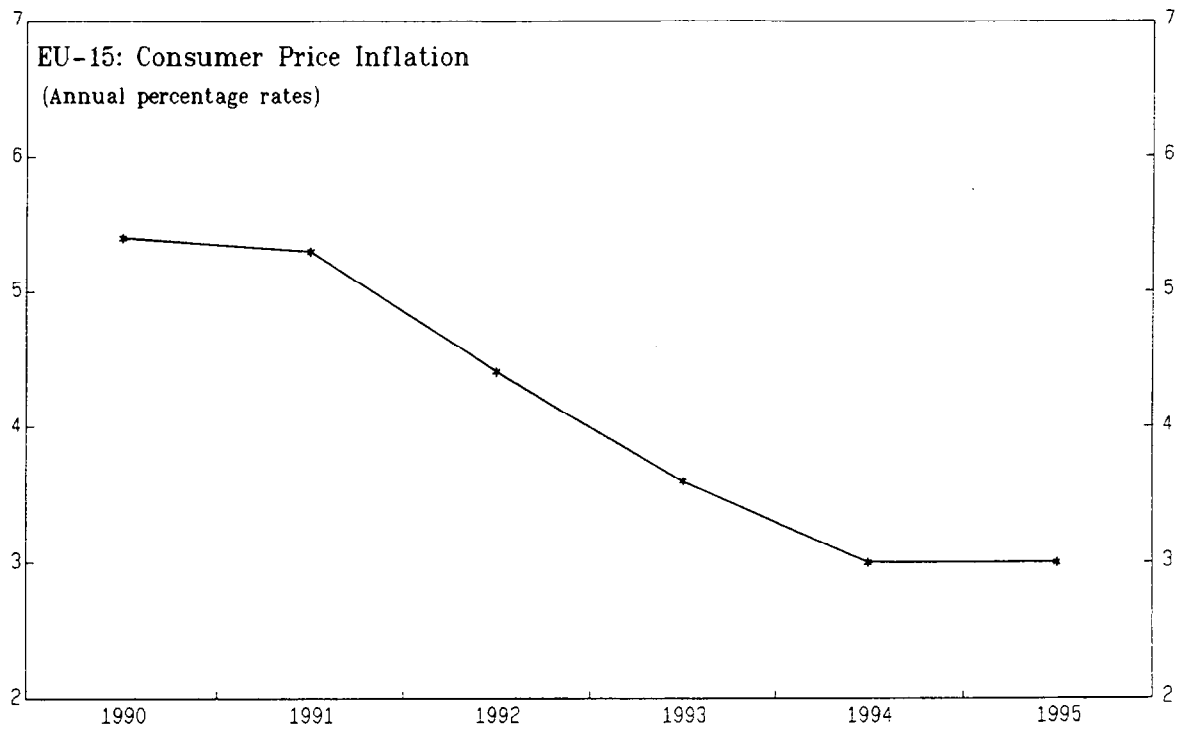
The treaty also mentions a number of other factors that should be addressed, including the results of the integration of markets, the balance of payments on current account, unit labor costs and other price indices. However, there is no provision for a broad consideration of developments in labor markets, although labor market policies have subsequently been attracting increasing focus in the context of EU surveillance.

Box 2. Surveillance of Economic Policies by European Union Institutions

The Maastricht Treaty provides for a considerable strengthening of surveillance by EU institutions, inter alia to support the convergence required in preparation for monetary union. The two principal channels of surveillance in Stage 2 are the Council and the European Monetary Institute.

- The broad economic policy guidelines provide the overall framework for the surveillance by the Council. They were issued first in December 1993 and are revised annually in the summer. The implementation of the guidelines is reviewed every winter. The goals established are more specific for fiscal policy and inflation than for other areas. There is also much attention to structural issues, especially in the labor market, but this is couched in broad terms. The guidelines have provided only very general advice on monetary and exchange rate policy.
- In the annual excessive deficit exercise, a country is designated as having an excessive deficit if it is judged not to be in compliance with the fiscal convergence requirements in the treaty. The Council issues a confidential finding to any country so designated in which it outlines its views on the fiscal policy needs, both in terms of overall deficit and the key policy components. The first exercise took place in the fall of 1994 and compliance with the advice given then will be examined in the spring of 1996. The treaty does not provide for specific penalties if countries fail to take adequate actions to correct excessive deficits during Stage II of EMU but countries that benefit from the Cohesion Fund may find their financing from this source in jeopardy if they fail to make adequate progress.
- Countries were required to submit convergence programs before the beginning of Stage 2, indicating how they intended to meet the treaty's convergence criteria (new members have also submitted programs). These programs have been reviewed by the Council. While there was no provision in the treaty for updating these programs, many countries have subsequently done so. The Council decided in 1994 that its surveillance would include a review of the execution of convergence programs and the evaluation of updated and revised programs. Convergence programs have been extensively used in the excessive deficit exercise to provide a benchmark against which to assess the pace of a country's adjustment.
- While not specifically provided for in the treaty, there is a growing emphasis on labor market issues. A European employment strategy was adopted by the European Council in Essen in December 1994, based largely on a 1993 Commission White Paper on Growth, Competitiveness and Employment. In the fall of 1995, member states have submitted multi-year programs in support of this strategy and the Council (of Ministers) will assess progress annually.
- The European Monetary Institute began operations at the start of Stage 2. In addition to making preparations for the European Central Bank and the operation of the single monetary policy, it is charged with strengthening the coordination of monetary policies and cooperation among national central banks and monitoring the operation of the European Monetary System. The central exercises in this context are the semi-annual monetary policy coordination exercises.

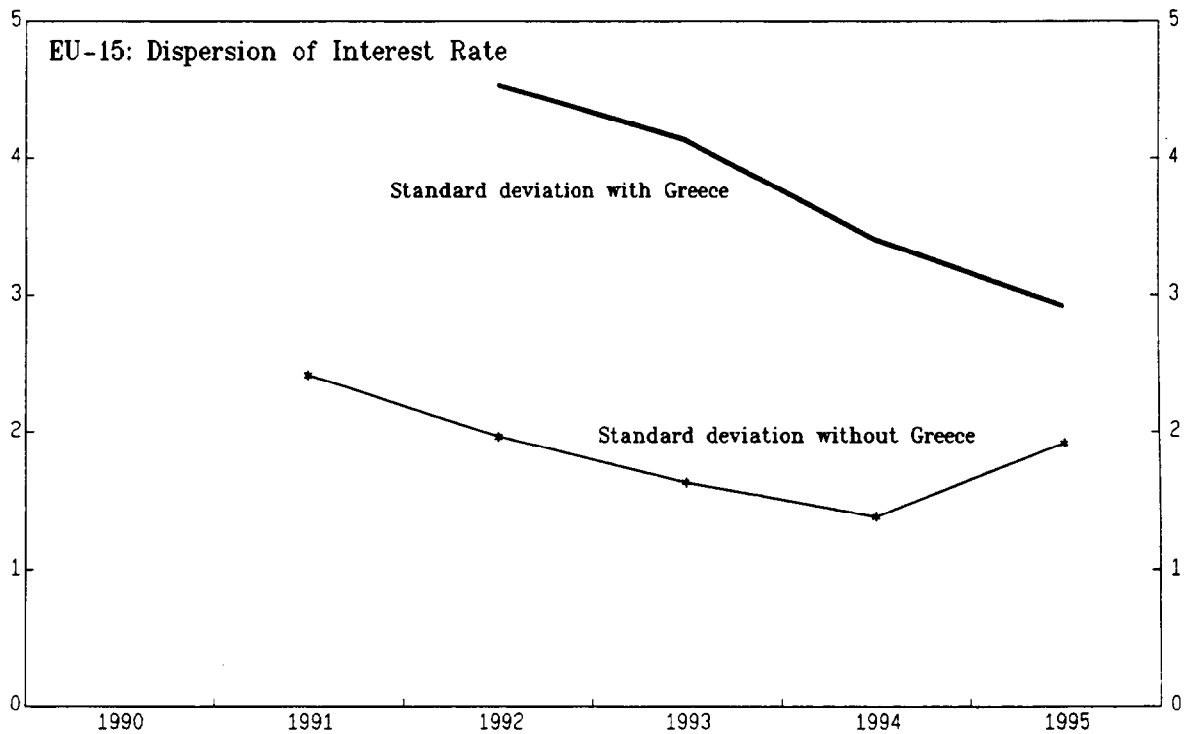
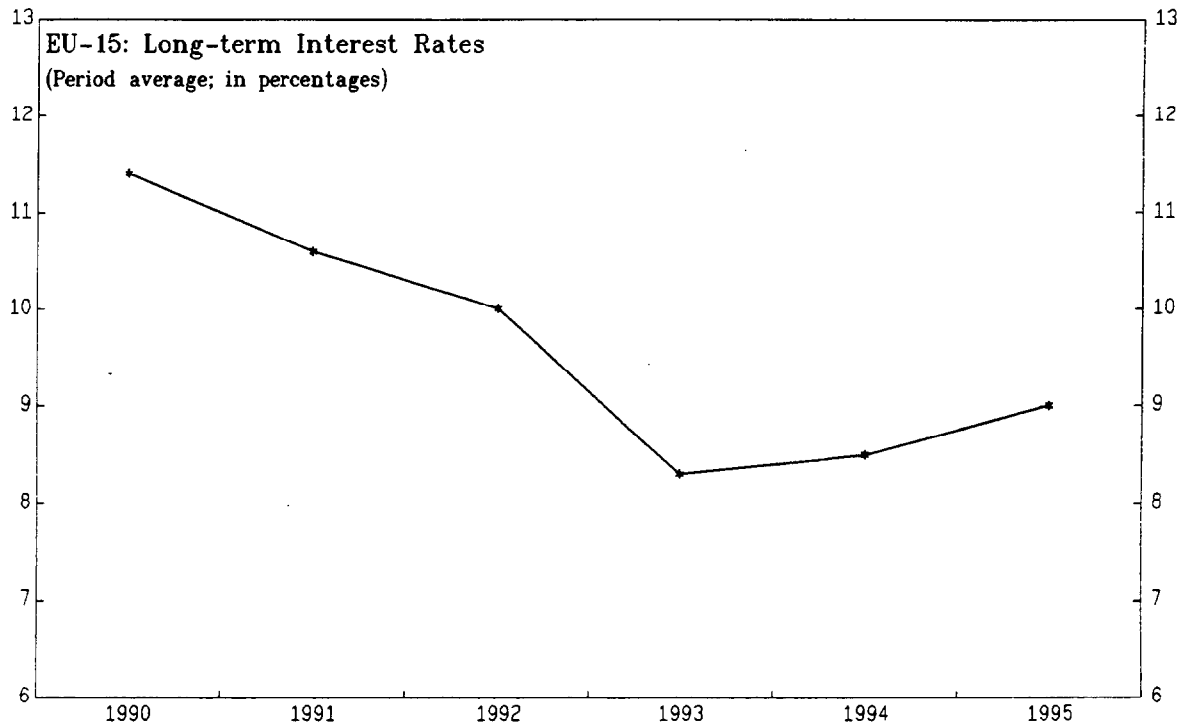
Chart 1
Inflation in the EU 1/



Source: European Monetary Institute, Progress Towards Convergence, November 1995.

1/ 1995 data relate to average inflation in the first nine months of 1995.

Chart 2
Long-Term Government Bond Yields in the EU 1/



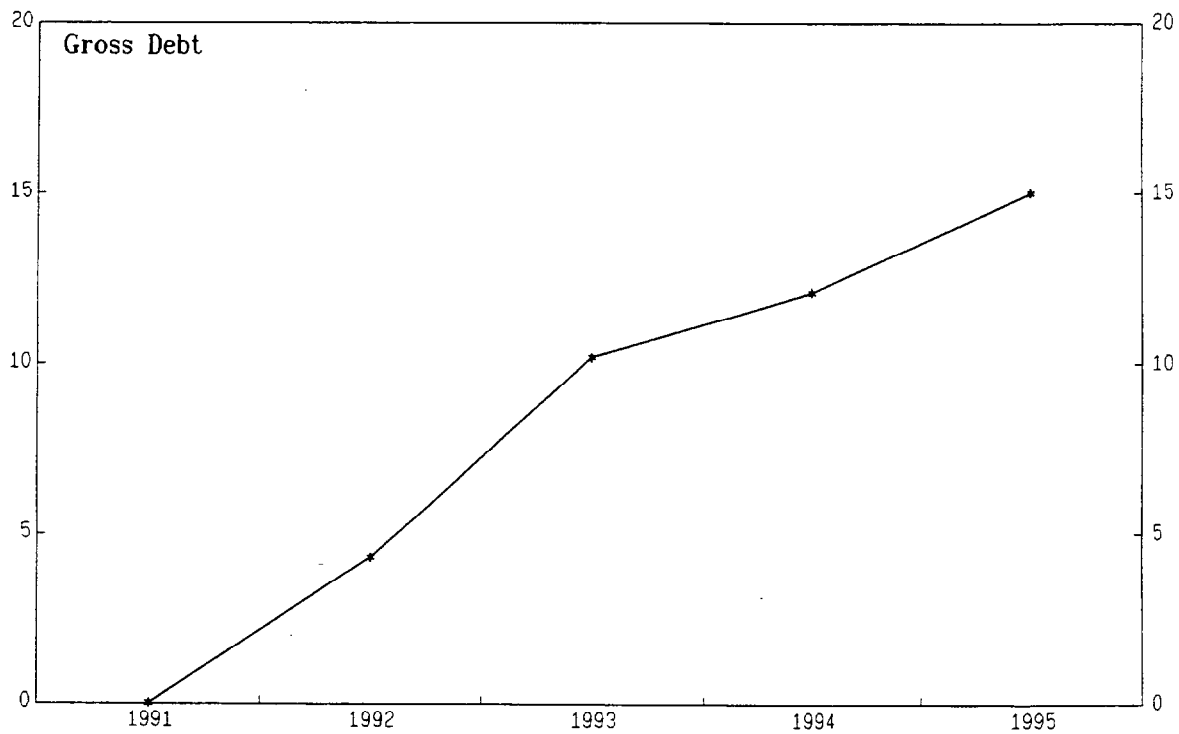
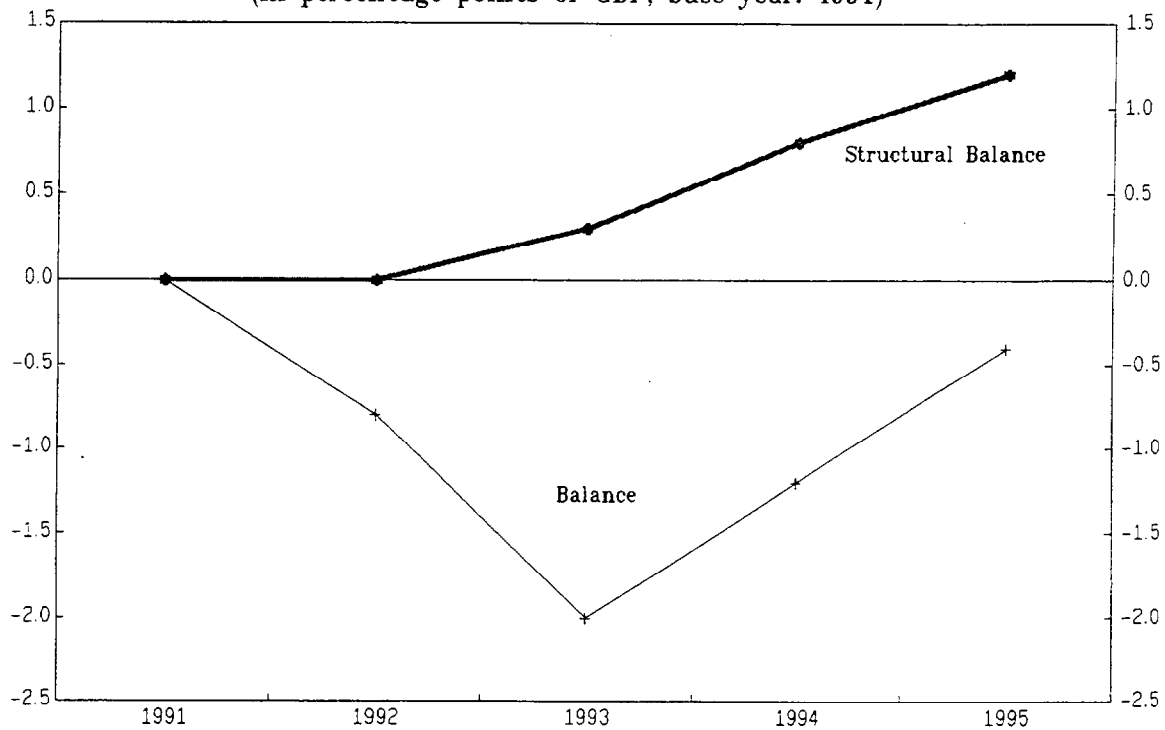
Source: European Monetary Institute, Progress Towards Convergence, November 1995.

1/ 1995 data relate to average yields in the first nine months of 1995.

Chart 3

European Union: Cumulative Changes in General Government Balance, Structural Balance, and Gross Debt 1/

(In percentage points of GDP; base year: 1991)



Source: European Monetary Institute, Progress Towards Convergence, November 1995.

1/ Data for 1995 are European Commission projections dated November 1995.

Table 1. European Union: Consumer Prices 1/
(Annual percentage changes)

	1990	1991	1992	1993	1994	1995 <u>2/</u>
Belgium	3.5	3.2	2.4	2.8	2.4	1.5
Denmark	2.6	2.4	2.1	1.3	2.0	2.2
Germany <u>3/</u>	2.7	3.6	4.0	3.6	2.7	1.9
Greece	20.3	19.6	15.9	14.5	10.9	9.7
Spain	6.7	5.9	5.9	4.6	4.7	4.8
France	3.4	3.2	2.4	2.1	1.7	1.7
Ireland	3.4	3.2	3.0	1.5	2.4	2.6
Italy <u>4/</u>	6.1	6.4	5.4	4.2	3.9	5.2
Luxembourg	3.7	3.1	3.2	3.6	2.2	2.1
Netherlands	2.4	3.1	3.2	2.6	2.8	2.1
Austria	3.3	3.3	4.0	3.6	3.0	2.4
Portugal	13.4	11.4	8.9	6.5	5.2	4.3
Finland	6.2	4.3	2.9	2.2	1.1	1.2
Sweden	10.4	9.7	2.6	4.7	2.3	2.9
United Kingdom <u>5/</u>	8.1	6.4	4.7	3.0	2.4	2.8
EU-15	5.4	5.3	4.4	3.6	3.0	3.0
Memo items:						
Maastricht reference value <u>6/</u>	4.1	4.4	3.8	3.1	3.1	3.0
Standard deviation of EU inflation rates <u>7/</u>	4.8	4.5	3.5	3.1	2.3	2.1

Source: Data are reproduced from European Monetary Institute, Progress Towards Convergence, November 1995, except for the standard deviation which is calculated by the Fund staff.

1/ Data are shaded where they are in excess of the Maastricht reference value, assuming that the reference value is calculated as set out in footnote 6.

2/ Data for 1995 are the average of the first nine months of the year.

3/ Western Germany up to end 1993, unified Germany thereafter.

4/ Cost-of-living index.

5/ CPI excluding mortgage interest payments (RPIX).

6/ Assuming that the 1½ percentage point margin provided in the treaty will be added to the average of the three best rates. The EMI's convergence report provided alternative calculations of the reference value.

7/ Unweighted standard deviation.

Table 2. European Union: Long-term Government Bond Yields ^{1/}
(In percent)

	1990	1991	1992	1993	1994	1995 ^{2/}
Belgium	10.1	9.3	8.7	7.2	7.8	7.7
Denmark	10.6	9.3	9.0	7.3	7.8	8.5
Germany	8.7	8.5	7.9	6.5	6.9	7.0
Greece ^{3/}	26.3	23.4	20.8	17.9
Spain	14.7	12.4	11.7	10.2	10.0	11.5
France	9.9	9.0	8.6	6.8	7.2	7.7
Ireland	10.1	9.2	9.1	7.7	7.9	8.4
Italy	13.5	13.3	13.3	11.3	10.6	12.4
Luxembourg	8.5	8.2	7.9	6.9	6.4	6.1
Netherlands	8.9	8.7	8.1	6.4	6.9	7.1
Austria	8.8	8.6	8.2	6.8	7.0	7.3
Portugal ^{4/}	...	17.2	13.8	11.1	10.4	11.7
Finland	13.5	11.8	12.0	8.8	9.1	9.2
Sweden	13.2	10.7	10.0	8.5	9.7	10.7
United Kingdom	11.6	10.1	9.1	7.4	8.0	8.3
EU-15	11.4	10.6	10.0	8.3	8.5	9.0
Memo Item:						
Maastricht reference value ^{5/}	11.4	10.7	10.8	9.3	10.0	10.2
Standard deviation of EU						
interest rates excluding Greece ^{6/}	...	2.4	2.0	1.6	1.4	1.9
Standard deviation of EU						
interest rates including Greece ^{6/}	4.5	4.1	3.4	2.9

Source: Data are reproduced from European Monetary Institute, Progress Towards Convergence, November 1995, except for the standard deviation which is calculated by the Fund staff.

^{1/} Data are shaded where they are in excess of the Maastricht reference value, assuming that the reference value is calculated as set out in footnote 6.

^{2/} 1995 data are the average of the first nine month of the year.

^{3/} Data are the only available from 30 September 1992. Precise data on long-term interest rates are not available. The data refer to variable coupon rates adjusted annually. As such, they cannot be used for comparisons with other countries, but only as a rough guide.

^{4/} Data are available only from January 1991.

^{5/} Assuming that the 2 percentage point margin provided in the treaty will be added to the average of yields in the three countries with the best inflation performance. The EMI's convergence report presented alternative calculations of the reference value.

^{6/} Unweighted standard deviation.

Table 3. European Union: Government Budgetary Positions
(As percentage of GDP)

	1990	1991	1992	1993	1994	1995 ^{1/}
General Government Balance						
Belgium	-5.8	-6.7	-7.1	-6.7	-5.3	-4.5
Denmark	-1.5	-2.1	-2.9	-4.5	-3.8	-2.0
Germany ^{2/}	-2.1	-3.3	-2.8	-3.5	-2.6	-2.9
Greece	-14.0	-11.4	-11.7	-12.1	-11.4	-9.3
Spain	-4.1	-4.9	-4.2	-7.5	-6.6	-5.9
France	-1.6	-2.2	-4.0	-6.1	-6.0	-5.0
Ireland	-2.3	-2.2	-2.4	-2.4	-2.1	-2.7
Italy	-10.9	-10.2	-9.5	-9.6	-9.0	-7.4
Luxembourg	4.9	1.9	0.8	1.8	2.2	0.4
Netherlands	-5.1	-2.9	-3.9	-3.2	-3.2	-3.1
Austria	-2.2	-2.4	-2.0	-4.1	-4.4	-5.5
Portugal	-5.5	-6.6	-5.3	-7.1	-5.8	-5.4
Finland	5.4	-1.5	-5.9	-8.0	-5.8	-5.4
Sweden	4.2	-1.1	-7.8	-13.4	-10.4	-7.0
United Kingdom	-1.5	-2.6	-6.1	-7.8	-6.8	-5.1
EU-15	-3.5	-4.3	-5.1	-6.3	-5.5	-4.7
General Government Gross Debt						
Belgium	130.9	130.3	131.1	137.5	135.0	134.4
Denmark ^{3/}	59.6	64.6	69.0	80.3	75.6	73.6
Germany ^{2/}	43.8	41.5	44.1	48.2	50.2	58.8
Greece	82.6	85.4	91.6	114.5	113.0	114.4
Spain	45.1	45.8	48.4	60.4	63.0	64.8
France	35.4	35.8	39.6	45.3	48.4	51.5
Ireland	96.5	96.7	94.3	97.4	91.1	85.9
Italy	97.9	101.3	108.4	119.4	125.4	124.9
Luxembourg	4.6	4.1	5.1	6.3	5.9	6.3
Netherlands	78.8	78.8	79.6	81.3	78.0	78.4
Austria	58.3	58.6	58.3	63.0	65.2	68.0
Portugal	68.6	70.2	62.4	67.2	69.4	70.5
Finland	14.5	23.0	41.5	57.3	59.8	63.2
Sweden	43.5	53.0	67.1	76.2	79.7	81.4
United Kingdom	...	35.7	41.9	48.6	50.1	52.5
EU-15	...	56.0	60.3	66.2	68.1	71.0

Source: Data reproduced from European Monetary Institute, *Progress Towards Convergence*, November 1995.

^{1/} European Commission projections, November 1995.

^{2/} Western Germany in 1990, unified Germany thereafter.

^{3/} General government gross debt figures are not adjusted for the assets held by the Danish Social Pension Fund against sectors outside general government, and for government deposits at the central bank for the management of foreign exchange reserves. In accordance with the Council's and Commission's statements covering Article 1 (4) of Council Regulation No. 3605/93 of 22 November 1993, for Denmark these items shall be stated separately. They totalled 20.8 percent of GDP in 1993, 16.3 percent of GDP in 1994 and are expected to be 13.3 percent of GDP in 1995. In addition, the data are not adjusted for the amounts outstanding in the government debt for the financing of public undertakings, which according to the aforementioned Regulation will be subject to a separate presentation for the Member States. In Denmark, this item amounted to 7.2 percent of GDP in 1993, 6.8 percent of GDP in 1994, and is expected to be 6.6 percent of GDP in 1995. If corrected by these items, the debt level at end-year would stand at 52.3 percent of GDP in 1993, 52.5 percent of GDP in 1994 and an expected 53.7 percent in 1995.

1995 than in 1991 by $\frac{1}{2}$ percentage point of GDP and the debt ratio rose by 15 percentage points over the same period. The picture is less disturbing when one looks at the structural balance, which for the EU as a whole has improved by $1\frac{1}{4}$ percentage points since 1991. Nevertheless, it is the view of the EU institutions, as it is of the Fund, that EU countries have not taken sufficient advantage of the current recovery to rein in structural deficits.

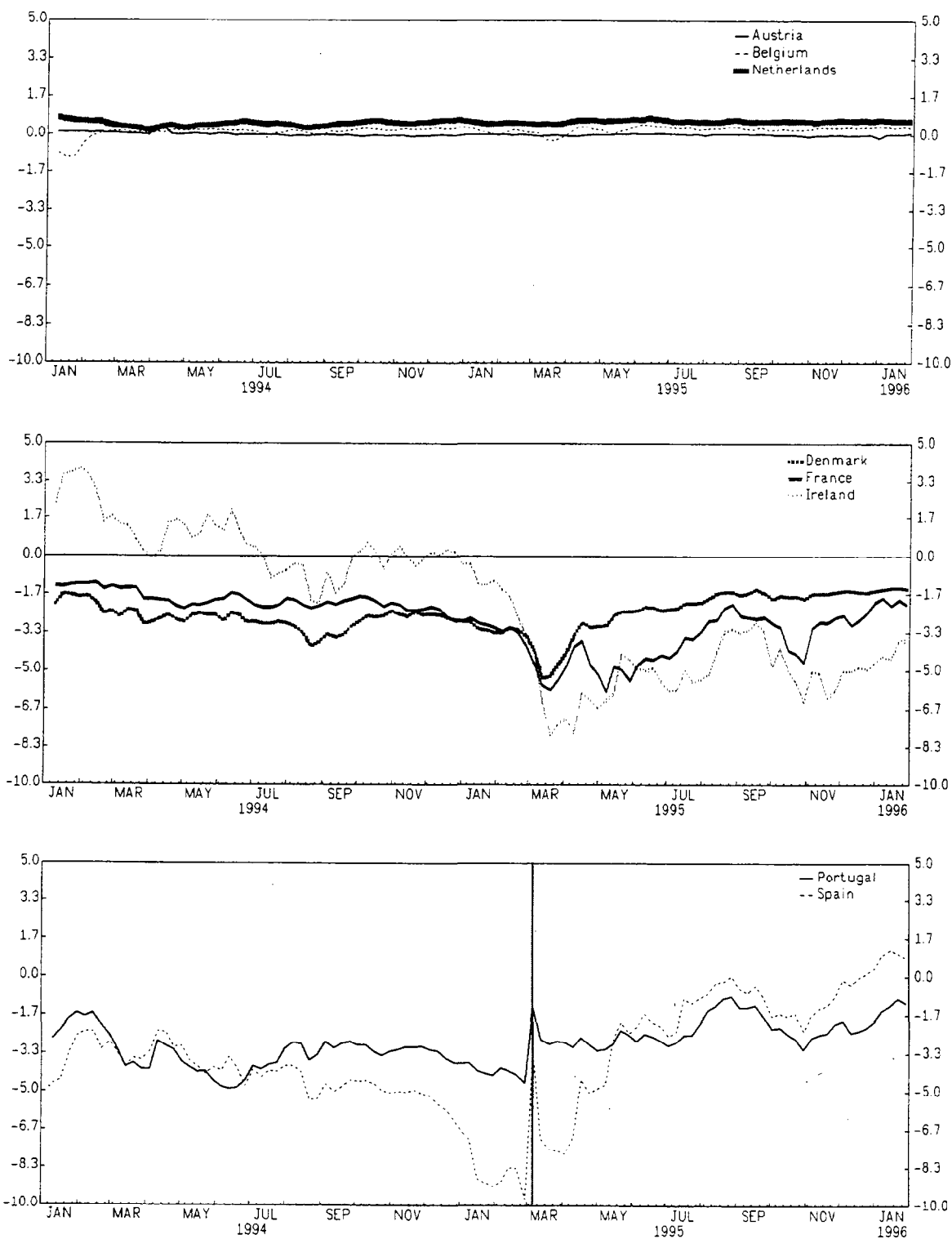
As regards the exchange rate criterion, both the Commission and the EMI limited their recent analysis to a description of developments. They did not assess whether countries were in compliance with the treaty's requirements, as it is not clear what is meant by the treaty's reference to "normal" margins since the widening of the ERM's $2\frac{1}{4}$ and 6 percent bands to 15 percent in August 1993. Developments in the foreign exchange markets, which are illustrated in Charts 4 and 5, have continued to underline the danger of market tensions as a result of uncertainties in the outlook for economic policies and/or a country's eligibility for EMU.

In 1995, conditions in the ERM were more unsettled than in the previous year, with the deviation of the strongest and weakest currencies from their bilateral central rate being in excess of 6 percent for much of the year; the Danish krone, the French franc, the Irish pound, and Spanish peseta were all at some stage during the year more than 6 percent depreciated from their central rate against the strongest currency, and on March 5, 1995, the central rates of the escudo and peseta were devalued by $3\frac{1}{2}$ percent and 7 percent, respectively. EU currencies outside the ERM have shown even greater fluctuations over the past two years than the ERM currencies. Three currencies (the Greek drachma, the Italian lira, and the pound sterling) all depreciated significantly against the deutsche mark. The other two either strengthened (Finish markka) or recovered lost value after initial depreciation (the Swedish krona).

The recent reports of the Commission and the EMI emphasize that many countries still face significant challenges in complying with the treaty's requirements. The assessment of where countries stand in relation to the convergence criteria is, however, complicated by uncertainties in the interpretation of the treaty. While the European Council confirmed at its December 1995 meeting that there would be a strict interpretation of the convergence requirements, the meaning of this is not clear where the treaty leaves room for judgement or is imprecise in its drafting. This is perhaps most obvious in the reference to the "normal" fluctuation margins of the ERM. The Council decided, in December 1994, not to provide an interpretation, inter alia, out of concern that narrowing the 15 percent margins, or establishing some goal within the margins, could incite speculation and disrupt the relative calm that had characterized the ERM over the preceding year.

Questions have arisen as to whether membership in the ERM should still be seen as a requirement for eligibility in Stage 3, as the ERM is a different system from what the drafters of the Maastricht Treaty had in mind, both in terms of the constraints placed on exchange rate movements and, given the widened margins, the degree to which intervention obligations support the central rates. The Swedish authorities have indicated that they do not see ERM participation as necessary for Stage 3 eligibility, a view that has recently been echoed by others. Such a view would also be consistent with the position of the U.K. authorities that they will keep their options open concerning participation in Stage 3, but will not rejoin the ERM. In their recent discussion with the Fund mission, however, the staffs of the Commission and the EMI emphasized that ERM membership was required by the treaty. They agreed with the mission that what was crucial was that the exchange rate be seen as sustainable, with exchange rate stability being an important factor in making such a judgment.

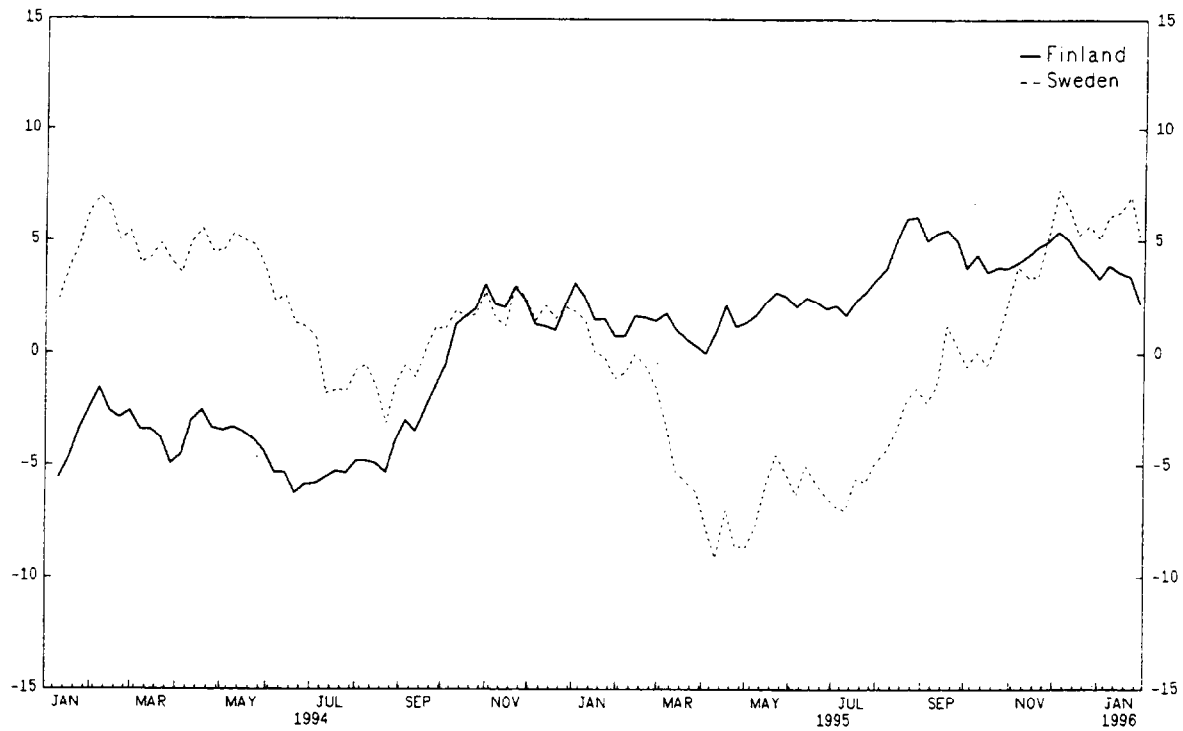
Chart 4
ERM Currencies: Deviations from Central Rates
Against the Deutsche Mark 1/2/
(Weekly average, in percentages)



1/ On March 5, the central rates of the Peseta and Escudo were devalued respectively by 7 percent and 3 1/2 percent.

2/ Positive number denotes appreciation.

Chart 5
Non-ERM Currencies: Deviations from Average Rates
Against the Deutsche Mark 1/
(Weekly average, in percentages)



1/ Based on average exchange rate against the deutsche mark of January 1994 - December 1995.
Positive number denotes appreciation.

In the case of the fiscal criterion, the treaty also gives rise to questions as to what deviations from the 3 percent reference value for the deficit ratio would be acceptable and what constitutes a debt level that is "sufficiently diminishing." The prevailing sentiment in the EU at present is to stress the importance of the 3 percent deficit reference value. With Ireland presently not subject to an excessive deficit finding, however, it is clear that countries with government debt ratios significantly in excess of the 60 percent reference value may qualify for Stage 3 provided that the debt ratio is declining sufficiently. In the case of the interest rate and inflation criteria, while the treaty does not define the reference values precisely, it is widely assumed that a simple average over the three countries with best inflation performance will be used, provided there is not a great dispersion in their inflation rates or in their interest rates. ^{1/}

A final issue of interpretation concerns whether the treaty's requirements are all of equal weight. This question has been given added relevance by the difficulties in interpreting the exchange rate criterion. The staffs of the Commission and the EMI took the position that there was no hierarchy to the criteria.

2. The start of Stage 3 and the changeover to the single currency ^{2/}

The Maastricht treaty is relatively quiet concerning the logistics of a change to the common currency and the timing of the key elements of the changeover. While it does set out a time frame within which Stage 3 should commence, it provides little guidance on the length of time or the specific steps that need to be taken: (1) between the decision to move to Stage 3 and the actual beginning of Stage 3; or (2) between the locking of exchange rates and the introduction of Euro notes and coins. Implicitly, the treaty leaves these matters to be addressed as part of the technical preparations by the Commission and the EMI. Over the past year, important progress has been made in this area and the strategy that has evolved, which is outlined below, was ratified by the European Council in Madrid in December 1995. ^{3/}

Concerning the starting date for Stage 3, the treaty indicates that the first assessment of whether Stage 3 should begin will take place no later than December 31, 1996 and that, if a starting date has not been set by the end of 1997, Stage 3 will commence on January 1, 1999. A decision to begin before January 1999 would require that a majority of member countries be judged ready to participate. It has been widely recognized for some time that a majority of countries would not meet the convergence criteria in time for Stage 3 to start in 1997. The Madrid European Council

^{1/} The recent convergence report of the EMI demonstrated that, for 1995 data, the results were not particularly sensitive to alternative methods of summarizing inflation and interest rates in the three countries with the best inflation performance.

^{2/} See Annex 2 for additional discussion.

^{3/} The key understandings were reached at informal meetings of ministers of finance and central bank governors in Versailles in April 1995, and in Valencia in September 1995. The Commission's preparatory work was published in *Green paper on the Practical Arrangements for the Introduction of the Single Currency*, May 31, 1995 and that of the EMI in *The Changeover to the Single Currency*, Frankfurt, November 1995.

confirmed "unequivocally" that the changeover to the single currency would commence on January 1, 1999. ^{1/}

Concerning the timing of the decision on eligibility for Stage 3, emphasis over the past year has focused on two requirements. First, it is now estimated that the decision will need to be made about one year before the start of Stage 3, to allow adequate time for the preparation of the single monetary policy, including the transfer of monetary policy authority by member states participating in Stage 3. The European System of Central Banks (ESCB), with the ECB at its center, is to be established immediately following the decision on the countries qualifying for Stage 3. Among its first tasks, the ECB will need to put in place its policy instruments and the macroeconomic framework for its operations. Contrary to what was initially widely assumed, this may require a considerable effort as a number of member states have taken the position that the ECB's decision making prerogatives cover not just the final decision on the framework, but also any preceding decisions needed to narrow the options; this circumscribes the scope of the preparatory work being undertaken by the EMI in conjunction with the national central banks (NCBs). ^{2/} The second requirement that has emerged is that the decision on eligibility should be based on actual data, not estimates. As reliable data on budget outturns become available with a lag, tension between the two requirements appears inevitable. The Madrid European Council indicated that this decision would be made as early as possible in 1998 with a view to allowing preparations for the single monetary policy to be completed by January 1, 1999.

There has been little focus as yet on how the shift from the independent monetary policies of Stage 2 to the single monetary policy of Stage 3 will be effected. In particular, there is no provision in the treaty for increased coordination of monetary policies after the ESCB is established; these policies will remain the responsibility of the NCBs up to the beginning of Stage 3. The treaty simply requires that there will be a single monetary policy from the start of Stage 3 and that the locking of exchange rates "shall by itself not modify the external value of the ecu" (where the treaty uses the term "ecu" to refer both to the single currency, now named the Euro, and the basket ECU, which will cease to exist at the end of Stage 2). There has been no formal interpretation of this latter provision, nor has there been an official view taken by the Commission or the EMI. At a technical level, it is generally expected that all currencies, including those qualifying for Stage 3, will bear the same value in relation to the Euro at the opening of its first trading day as they had in relation to the basket ECU at the close of its last trading day. This would imply that market rates prevailing just prior to the beginning of Stage 3 will be used as the basis for locking the exchange rates of currencies participating in Stage 3.

Concerning the time frame for the introduction of the single currency, the treaty requires that the Council, after adopting fixed conversion rates for the currencies of the participants, will "take the other measures necessary for the rapid introduction" of the Euro. As a practical matter, it is not seen to be possible to introduce the Euro in one step at the start of Stage 3. For example, a

^{1/} Some of the requirements of the treaty that are keyed into a potential 1997 start date will still have to be observed. Thus, there will need to be a first formal assessment of whether to move to Stage 3 by the end of 1996.

^{2/} This is not seen to preclude progress in narrowing the options where a consensus exists. However, it is expected that, in areas where there are important differences of view (e.g., the role of reserve requirements), it may be easier to reach agreement among the smaller group of countries that in all likelihood will move initially to Stage 3.

decision on notes and coins is to await the establishment of the ECB and it is envisaged that the design and manufacturing of banknotes and coins will take 2-3 years after that. Moreover, given the costs involved, economic agents cannot be expected to begin taking practical measures for the changeover until its modalities and the participation of their own country are known.

The debate over the past year has revolved around how the use of the Euro should evolve prior to the introduction of notes and coins. One view was to promote early credibility by requiring that the Euro be used for certain transactions upon its creation; a very different alternative was to opt for a delayed "big bang" so as to reduce costs and frictions associated with the coexistence of two units of account. The former view was defended by the Commission, notably in its green paper, which argued that the credibility needed to make the changeover irreversible should be secured by achieving a "critical mass" of transactions in the single currency soon after entering Stage 3. A delayed big bang was advocated particularly by Germany which saw a need to save its numerous small banks the expense of operating simultaneously in the European and the national currency, as would be unavoidable under a phased changeover.

At its December 1995 meeting, the European Council adopted a framework, based on the preparatory work of the Commission and the EMI, within which Euro notes and coins will be introduced no later than January 1, 2002, with national notes and coins withdrawn no later than July 1, 2002. 1/ This framework satisfies important concerns underlying the two approaches mentioned in the previous paragraph. The ESCB will operate exclusively in the Euro from the start of Stage 3, which would be expected to entail its general use as unit of account in the money market and the foreign exchange market. Moreover, new tradable public debt will be denominated in Euro. Except for the banks' transactions with the ESCB, however, there will be no obligation on banks or on other economic agents to use the Euro until national notes and coins cease to be legal tender, but they will be free to do so. The cost of the temporary coexistence in each participating country of two monetary units, the Euro and a national one, will be limited by means of "conversion facilities" to enable payments expressed in either of the two monetary units to be processed by financial intermediaries and the interbank funds transfer systems. 2/

3. The policy framework for Stage 3

a. Monetary policy 3/

The EMI has been assigned the task of preparing the ground for the single monetary policy. The key design considerations are that the system be operationally efficient, conform with market

1/ No important difficulties are seen in ensuring the continuity of financial contracts when national currencies are withdrawn (see Annex 2).

2/ The NCBs will provide such facilities for financial institutions for whom they would otherwise be too costly in order to enable them to deal with the NCBs in the national monetary units, in particular for monetary policy operations. The same will apply to other public and private agents which have an account with the NCBs.

3/ For further information on the material in this section, see *The Operation of Monetary Policy in European Economic and Monetary Union* (SM/95/217, 8/25/95).

principles, and facilitate decentralization of the execution of the ECB's monetary policy decisions. 1/

An essential feature for conducting a unitary monetary policy in the Euro area will be a payment system that integrates national financial markets fully. Over the past year and half, considerable progress has been made in designing such a system in the critical area of large-value payments. In particular, it has been decided that the EU-wide payment system (named TARGET) will be composed of a real time gross settlement (RTGS) system in each country and an interlinking system. Work is already well advanced (where needed) in converting national payment systems to RTGS and it is expected that these systems will be operational in twelve member states by end-1996 and in the remaining three in the course of 1997. In 1996, attention will focus on formalizing procedures for linking national systems and coordinating their operating procedures in areas where this is deemed necessary, such as opening hours, prices, and intraday liquidity. The RTGS payment systems in EU countries not participating in Stage 3 will have access to the TARGET system provided they are capable of dealing in the Euro. It has also been decided that, consistent with the emphasis on market principles, the TARGET system will not have a monopoly of large-value cross border transactions. 2/

There has been significant progress in identifying the operating procedures and instruments to be used by the ESCB, though many of the details remain to be filled in, and formal decisions will in any case await the establishment of the ECB. It is envisaged that regular open market operations, on a predetermined timetable, will be the main tool to be used in guiding the markets, supplemented by "quick tenders" as needed to respond to unexpected shocks to liquidity. Standing facilities would be used to provide the upper and, probably also, the lower bound to the movement of short-term market rates—a facility such as the German Lombard window to set the upper bound, with a deposit facility likely to be used as the lower bound. Among the outstanding issues in the general design are the roles of a below-market discount window and reserve requirements. In addition, there are complications, notably for reserve requirements, that stem from long lead times for implementation once a decision has been reached. In view of these lead times, there is concern that leaving matters open until the ECB has been established may exclude some possibilities. Finally, it is also expected that institutional differences in financial markets will continue to narrow (e.g., the relative importance of variable and fixed interest rates in contracts).

As regards the macroeconomic framework for policy, the key issue is whether the future central bank will adopt a monetary target, or will formally target inflation. Irrespective of which is chosen, there will be a difficult initial phase as the change of regime could well invalidate preexisting relationships relating to the transmission of monetary policy. Monetary targeting has the advantage that it has been followed successfully by the Bundesbank for 20 years. In this, the Bundesbank has been able to benefit from its credibility in implementing this approach in a flexible manner; its success may also have been facilitated by efforts to limit financial innovation at the short-end of the German markets. It will be less easy for a new institution, with its credibility not

1/ Decentralization is seen as desirable to take advantage of the extensive operational experience and local market knowledge of the NCBs which, inter alia, could help reduce transitional problems at the start of Stage 3. However, it is agreed that the application of this principle should not conflict with operational efficiency.

2/ For example, the system currently used for clearing private ECU could continue to play a role.

yet established, to adopt the flexible approach to monetary targeting that may be needed during the initial years of Stage 3, when the demand for money may be particularly difficult to establish. ^{1/} However, the information needed to implement inflation targeting at the beginning of Stage 3 will also be difficult to interpret and the greater discretion in this approach carries its own inherent complications for an institution that is building its credibility.

b. Exchange rate relations with non-participating EU currencies

As it appears likely that not all member states will join the monetary union from its inception, attention has begun to focus on future exchange rate relationships between nonparticipating currencies and the Euro. While the treaty provides for the possibility of delayed participation of countries, it does not define the exchange rate relations between their currencies and the Euro. An arrangement is seen to be needed because the obligation to meet the convergence criterion for exchange rate stability remains in force for the countries wishing to enter the monetary union at a later time. In light of developments of the past few years, concerns have also arisen that in the absence of an arrangement, fluctuating exchange rates of the nonparticipating countries could cause problems for the single market. ^{2/}

As part of the work requested by the European Council, the Commission recently prepared a brief paper on the basic requirements to be met by an arrangement for the relations between the single currency and the currencies of the member states not in Stage 3. ^{3/} This paper lists a number of principles for the design of an arrangement: it should provide a framework for the non-participating countries to prepare for Stage 3; it should neither disturb markets nor interfere with the conduct of the single monetary policy; and it must be both credible and sustainable and be perceived as such by the markets.

In discussions with the staffs of the EU institutions, some additional considerations were noted. First, there could be significant differences in the situations facing non-participating countries, which could necessitate variation in the approach for different groups of countries. Some non-participating countries might be quite close to qualifying for Stage 3 and interested in a tight

^{1/} There have been a number of studies, including some at the Fund, which have found a stable demand for money among a core of ERM members. For a survey of the literature and some new estimates, see M. Cassard, T. Lane, and P. Masson, *ERM Money Supplies and the Transition to EMU*, in P. Masson, ed., France: Financial and Real Sector Issues, IMF, 1995. However, as noted above, it is open to doubt whether such relationships would carry over unaltered to Stage 3.

^{2/} At the request of the European Council, the Commission released a study in October 1995 on *The Impact of Currency Fluctuations on the Internal Market*. In addition to the uncertainty engendered by market turbulence and the large fluctuations in exchange rates, the study noted that there had been significant longer-term changes in real exchange rates in a number of cases (using early 1987 as a basis for assessment). It argued that currency turbulence had cut EU growth by $\frac{1}{4}$ to $\frac{1}{2}$ percent in 1995, was adversely affecting investment, creating adjustment difficulties for specific sectors, and boosting interest rates and inflation in countries whose exchange rates had come under pressure. The report concluded that a single currency was the essential complement to the single market.

^{3/} European Commission, *Exchange Rate Relations between Participating and Non-Participating Countries in Stage Three of EMU*, Interim Report to the European Council, November 29, 1995.

exchange rate relationship with the Euro to facilitate the transition to participation; other countries might have still some way to go in convergence before they were in a position to sustain a tight exchange rate relationship; and, any countries not wishing to participate in Stage 3 might see the need for flexibility on a more permanent basis. Second, and overlapping the first set of considerations, there could be complications in some cases resulting from different goals for the management of the exchange rate of non-participating countries against the Euro. Concerns about the impact of real exchange rate changes on the operation of the internal market could focus attention on means of stabilizing real exchange rates. However, this would have to be reconciled with the need to provide the discipline that would foster nominal convergence. The tension between these two goals could be marked where nominal divergence remained significant. Third, there was the legal consideration that the nature of an exchange rate arrangement in Stage 3 should not pose a more burdensome exchange rate convergence criterion than will be applied to countries participating in Stage 3 from the beginning.

c. Policy surveillance in Stage 3

The Maastricht Treaty provides for a continuation in Stage 3 of the main macroeconomic surveillance instruments of Stage 2—the broad economic policy guidelines and the excessive deficit procedure. According to the treaty, the excessive deficit procedure in Stage 3 will follow the practice prevailing in Stage 2, and be tied into the same reference values for the general government deficit and debt. However, in Stage 3, the Council will have the ability to impose sanctions (including fines or requiring interest free deposits) on transgressing countries. In recent months, a debate has emerged concerning whether the treaty provides for sufficiently strict surveillance of fiscal policies in Stage 3. There have been two points of concern: first that the treaty did not make it sufficiently clear that in "normal" times deficits should be significantly below the 3 percent reference value, and second that the procedures for sanctions were cumbersome and not sufficiently automatic. ^{1/} In November 1995, the German authorities submitted to the Council a proposal addressing these concerns, under which participants would commit themselves in a separate agreement to tighter Stage 3 surveillance of fiscal policy (see Box 3). At the first Council discussion of the proposal, there appears to have been broad acceptance of the need for tightening the provisions governing Stage 3 surveillance, and the matter has been referred to the Commission for further study.

A related debate is whether there is a need for a central fiscal policy function in the EU to facilitate the response to shocks. From one perspective, it has been noted that existing federal systems have relied on an important element of central stabilization, but this has been countered by the observation that national governments could achieve a similar degree of stabilization on their own. From a second perspective, questions have been raised as to whether the need for fiscal stabilization in the EU would increase in a monetary union, compared with past experience, and whether the scope for variation of national fiscal positions might be more constrained by surveillance procedures in Stage 3. Clearly, to the extent that monetary and exchange rate policies have been used as instruments of stabilization in the EU, there will be an additional burden on fiscal policy in dealing with asymmetric shocks in Stage 3. However, with a single monetary policy, and with strict surveillance of fiscal policies, the frequency and size of shocks induced by national policies may diminish. Whether the demand for fiscal stabilization increases will also depend, for example, on the extent to which labor markets become more flexible. The room for maneuver of

^{1/} See Annex 3 for further discussion on the first of these points.

**Box 3. Proposal of the German Authorities for the Surveillance
of Fiscal Policies in Stage 3**

Under the proposal of the German authorities, countries would agree to:

- take account of the requirements for stability in Europe;
- contain the rate of increase in public expenditure below the growth of nominal GDP, over the medium term, with a view to lowering the ratio of public expenditure to GDP;
- keep deficits under 3 percent of GDP implying an upper limit of 1 percent in "normal" times. Deficits in excess of this ceiling could be allowed in exceptional cases with the approval of a qualified majority in the Council.

Adherence to the 3 percent limit would be subject to surveillance twice a year. If a budget or an outturn exceeded the limit, sanctions would be imposed automatically. The transgressing country would make an interest free deposit of $\frac{1}{4}$ percent of GDP per percentage point in excess of the limit, or part thereof. The deposit would be returned if the country was back within the limit in two years, but otherwise would be relinquished as a fine.

national fiscal authorities will clearly be more constrained, unless structural deficits are kept sufficiently low to allow adequate flexibility within the upper limit placed on the deficit and this limit can be exceeded in exceptional circumstances. 1/ From a third perspective, a central system of automatic stabilization can help spread risk in a monetary union, but the design of such a system is complicated, inter alia, by the need to limit adverse incentive effects (e.g., on inter-regional mobility) and difficulties in separating trend developments from shocks. There are no plans at present within the EU to consider providing macroeconomic functions to a central fiscal institution.

III. Policy Issues in the Transition

The key challenge facing the EMU process is the promotion of an orderly transition to Stage 3, culminating in a monetary union which has both a strong foundation, conducive to the credibility of the ECB, and as wide as possible a participation among EU countries. In assessing threats to an orderly transition, the key issues are the macroeconomic effects of policies aimed at achieving convergence and how the markets react to the EMU process more generally. As regards the former, the large fiscal adjustments that remain to be made by a number of countries, together with the recent slowdown in EU growth, have renewed concerns addressed earlier in SM/92/129 that the interaction of fiscal consolidation measures pursued simultaneously in a number of countries could have an excessively contractionary effect on the EU's economy. 2/ As to market conditions, there are important uncertainties affecting a number of facets of the process that could spark tensions. First, while the EMU process has regained momentum over the past year or so, uncertainty remains as to whether Stage 3 will be realized on the schedule envisaged, and this may well intensify if the current slowing of economic growth in Europe should persist. In the runup to the decision on participation there also will be doubts as to whether individual countries will qualify and what might be the effects of a failure to qualify on their policies in general and their exchange rates against the Euro in particular. As regards countries participating in Stage 3 initially, there will be uncertainties as to where exchange rates will end up on the eve of Stage 3, which is likely to be the basis for locking; after the decision is made on the eligibility of countries, there is no formal restriction in the treaty on exchange rate fluctuations for these countries until rates are locked. Finally, once Stage 3 has begun, there may still remain questions as to whether individual countries are irreversibly committed to monetary union, especially prior to the withdrawal of national currencies. These various issues will be addressed below in the context of the policy strategies of countries in preparation for Stage 3, as well as the design of the process as a whole. In the case of the former, as the domestic effects of countries' policies are extensively discussed in Article IV consultations, the emphasis will be on policy interactions that could entail significant spillover effects on other countries.

1/ Even if there is a commitment to keeping structural deficits sufficiently low in Stage 3 and there is provision for exceptional circumstances, there could be obvious complications in the early years of Stage 3, if a slowdown emerged before all countries had achieved structural deficits in line with medium-term goals.

2/ The latest staff assessment is that economic growth in the EU in 1995 was about ¼ percentage point slower than envisaged in the October 1995 WEO. For 1996 and 1997, it is now expected that growth in the EU will be about ½ percentage point and ¼ percentage point, respectively, lower than projected in October 1995.

1. National economic policies

a. Fiscal policy

There is no question that the individual EU countries need to reduce their fiscal deficits ultimately well below the Maastricht reference criterion of 3 percent of GDP. A key issue for those with relatively high deficits is the speed with which this should be done. The advice given by the EU in its surveillance is that countries should opt for relatively fast adjustment. Thus, in the excessive deficit procedure, it has urged that countries, as a minimum, respect the targets of their convergence programs, which entail reducing the deficit to below 3 percent of GDP by 1996 or 1997, except for Greece and Italy where the target date is 1998. Fund advice in Article IV consultations has been broadly similar.

In their multilateral surveillance exercises, which are more suited to taking account of interactive effects, the Fund and the EU have both emphasized the gains from fiscal consolidation. Thus, in its broad economic policy guidelines, the EU has stressed the risk to the durability of the recovery from inadequate fiscal adjustment, particularly in those countries with the largest deficits; failure to address fiscal issues adequately would have costs in the form of high real interest rates, adverse inflation expectations, and continuing high unemployment. In the October 1995 WEO, the staff used MULTIMOD to illustrate the important benefits of credible fiscal consolidation efforts (combined with labor market reforms) in the industrial countries. While there were moderate, upfront output costs to adjustment, the recovery was seen to offer an important window of opportunity to lay the basis for longer term gains. ^{1/}

To explore this question in greater detail for the EU countries, the staff has used MULTIMOD to simulate some alternative scenarios on fiscal adjustment. The exercise assumes a baseline scenario in which there would be no adjustment to the structural primary deficit until well into the next decade, with interest rate premia vis-à-vis the deutsche mark staying broadly unchanged at their average 1995 level during the period under investigation (1996-2000). ^{2/} Chart 6 illustrates for each country in 1997 the combination of general government deficits and long-term interest rates in the baseline. ^{3/} For a number of countries (Denmark, Finland, Ireland, and the Netherlands) only a limited or no additional fiscal effort is needed to meet the Maastricht reference value for the deficit by 1997, although further consolidation is warranted in most of them to meet longer term goals. ^{4/} These countries (with the exception of the Netherlands) have long-term interest differentials against Germany in the baseline of a size that one

^{1/} It should be noted that, in the October 1995 WEO, the fiscal adjustment was spread over a longer period than assumed in the scenarios described below.

^{2/} The construction of the scenario is described in Annex 4. It is based on preliminary work for the Spring 1996 WEO, but excludes fiscal measures (and the economic effects of these measures) that are built into the WEO projections for 1996 and later years. Thus, in the baseline scenario, fiscal deficits in relation to GDP can fall below their 1995 levels, but only owing to a narrowing of the output gap or a reduction in interest spending.

^{3/} The model does not include a separate module for Luxembourg.

^{4/} In its broad economic policy guidelines, the EU has set a goal of reducing the EU-wide fiscal deficit to between zero and 1 percent of GDP by the end of the century, with a surplus deemed warranted in some countries depending on the structure of public pension funds.

would not expect to persist in monetary union. 1/ A second group of countries (Belgium, France, Germany, Portugal, and the United Kingdom) have intermediate fiscal adjustment needs—between $\frac{1}{4}$ and $1\frac{1}{4}$ percentage points of GDP—if they are to reduce their deficits to 3 percent of GDP by 1997. Among these countries, the interest rate benefits for the United Kingdom and especially Portugal could be quite important. Of the five member states with the largest fiscal adjustments to make (Austria, Greece, Italy, Spain, and Sweden), all but Austria have large potential benefits from lower interest rate premia.

Scenario A illustrates the implications of rapid fiscal adjustment, in which all countries with 1997 baseline deficits greater than 3 percent of GDP take expenditure measures to reduce the deficit to 3 percent (Table 4). 2/ It is assumed that the measures are front-loaded (two-thirds in 1996) and are perceived by the markets to be credible with the result that interest differentials related to exchange rate risk (but not sovereign risk) decline steadily and disappear by 1999, as countries move to monetary union (Chart 7). Exchange rates are held stable within the EU. Overall, meeting the Maastricht convergence criteria entails an ex-ante reduction in the EU-wide fiscal deficit of about $1\frac{1}{4}$ percent of GDP over 1996-97. There is a decline in average EU growth in 1996-97 of about $\frac{1}{4}$ percentage point a year—with a sharper reduction in the initial year, partially offset by a recovery in the following year. 3/ Over 1996-2000 as a whole, growth is stronger than in the baseline. For the five high-deficit countries, the slowdown in 1996-97 is more pronounced, with growth lower by $\frac{1}{2}$ percentage point a year (again with a sharper decline in the initial year), but over the five-year reference period as a whole growth is stronger by $\frac{1}{2}$ percentage point a year. The initial contractionary stance also generates a marked reduction in inflation in these countries. The overall effects on countries outside the EU are negligible, although for some countries with close ties to the EU (e.g., other European countries and the CFA countries in Africa), they are likely to be more important. The key to the generally benign outcome in this scenario is the behavior of interest rates: lower real interest rates in the EU boost investment and also facilitate the adjustment process by reducing government interest spending.

Scenario B considers an alternative in which the ex-ante fiscal adjustment is the same but not judged to be sustainable over the longer term by the markets. To reflect this lack of credibility, the scenario adopts the polar assumption that the EU countries do not see any reduction in their interest rate differentials against Germany. In this scenario, the short-run output costs are significantly larger than in Scenario A for the EU as a whole, but especially for the high-deficit countries. The latter countries also experience slower growth over 1996-2000 than in Scenario A. For the EU as a whole, however, the average growth rate over a five year period is similar to that in Scenario A.

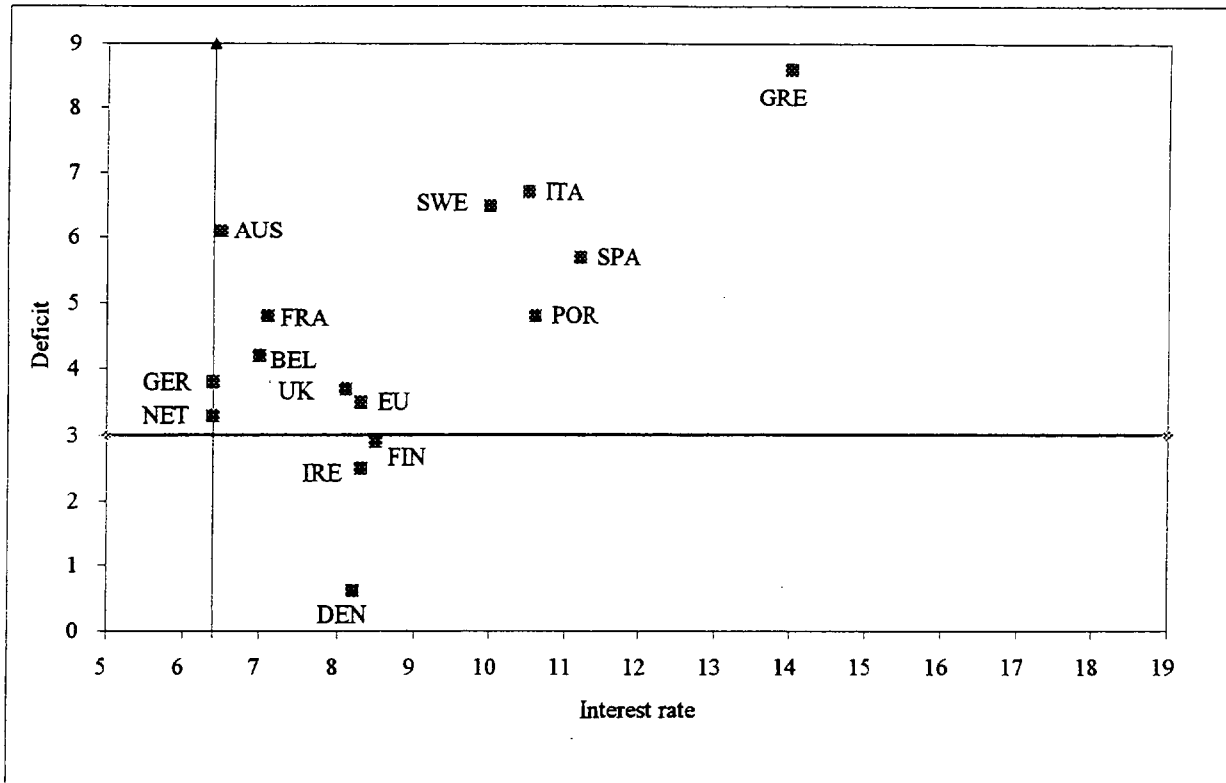
Scenario C assumes a slower, but credible, pace of convergence for those countries with the most difficult situations as judged by their initial convergence positions, namely Greece, Italy,

1/ The premium for sovereign risk in the past has been small for EU countries, typically much less than 50 basis points (see Annex 3). For some countries, however, this premium could rise following monetary union, as they will no longer have the option of reducing debt through inflation.

2/ The measures are calibrated to close this gap ex ante; the deficits emerging in the scenarios for 1997 also depend on how consolidation affects output and interest rates. Use of revenue measures instead of expenditure measures would be expected to result in smaller initial demand effects but also smaller benefits over the medium term.

3/ Results for individual years are reported in Annex 4.

Chart 6
General Government Deficit and Long-Term Interest Rate 1/
(Baseline Scenario, 1997)

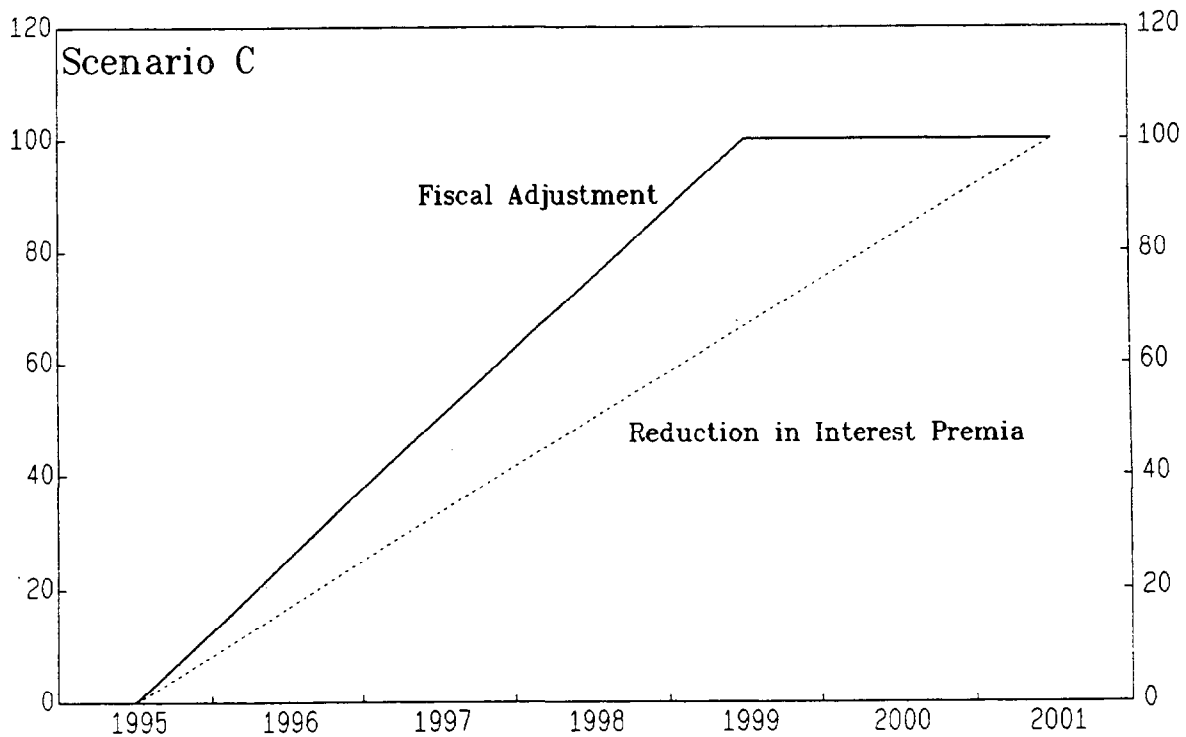
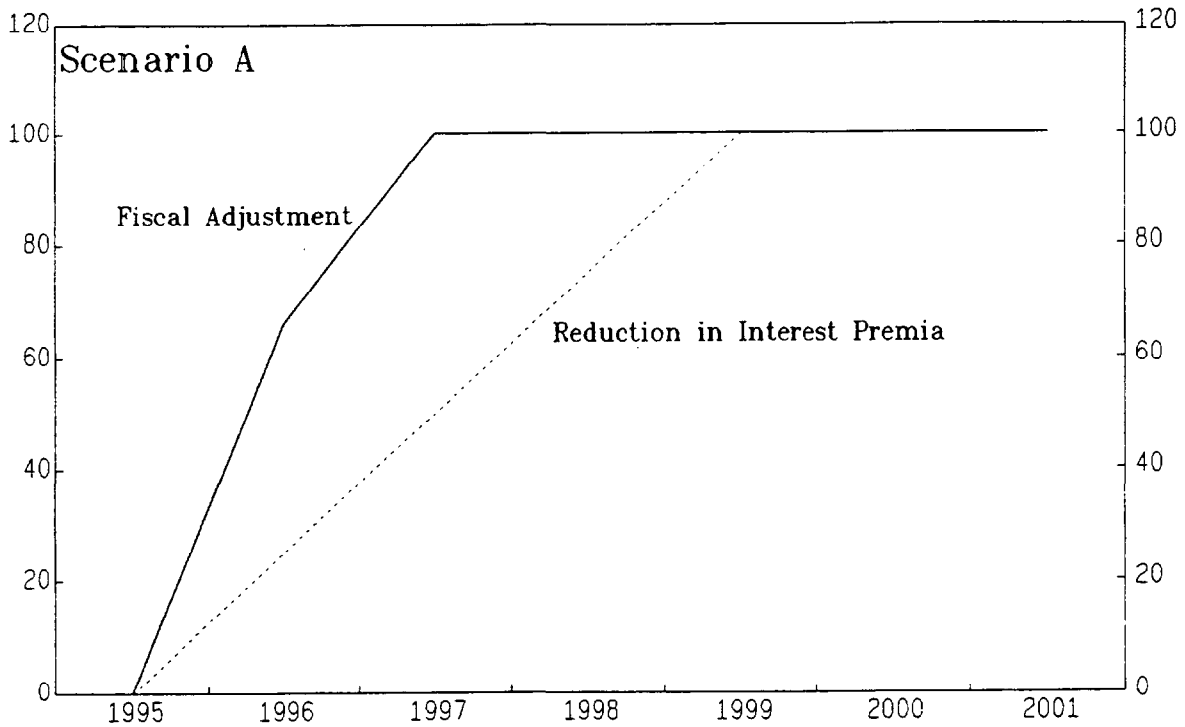


Source: Fund staff estimates.

1/ Assuming the same primary structural deficit and same year-average interest rate differential against the deutsche mark as in 1995.

Chart 7

Higher Deficit Countries: Profile of Fiscal Adjustment and
Assumed Credibility Gains in Scenarios A and C 1/
(In percent completed) 2/



1/ In scenario B, the profile of fiscal adjustment is the same as scenario A and there is no reduction in interest premia.

2/ The charts show the cumulative share of the simulated fiscal adjustment measures completed or the cumulative share of the assumed decline in interest premia (other than sovereign risk premia) realized.

Table 4. Fiscal Convergence Scenarios: Deviations from Baseline 1/

	1996-1997			1996-2000		
	A	B	C	A	B	C
GDP growth						
EU-15	-0.2	-0.6	-0.1	(ln percent per annum)	0.2	0.2
Higher deficit countries 2/	-0.4	-1.3	--		0.4	0.2
Intermediate deficit countries 3/	-0.1	-0.3	-0.1		0.1	0.2
Lower deficit countries 4/	0.2	--	0.4		0.1	0.1
Non-EU industrial countries	--	--	--		--	--
General government balance						
EU-15	1.9	1.5	1.3	(ln percent of GDP, end of period)	2.1	2.2
Higher deficit countries 2/	3.8	2.9	2.1		4.3	4.4
Intermediate deficit countries 3/	1.2	1.1	1.1		1.4	1.4
Lower deficit countries 4/	0.2	--	0.2		0.1	0.1
Non-EU industrial countries	--	0.1	--		--	--
Short-term interest rate						
EU-15	-1.1	0.2	-0.5	(ln percent)	-2.3	-1.1
Higher deficit countries 2/	-1.7	0.2	-0.7		-3.6	-1.8
Intermediate deficit countries 3/	-0.8	0.2	-0.4		-1.7	-0.7
Lower deficit countries 4/	-1.0	0.2	-0.4		-2.1	-1.1
Non-EU industrial countries	--	-0.2	--		0.1	0.1
Inflation						
EU-15	-1.2	-1.2	-0.7	(ln percent per annum)	-1.1	-0.5
Higher deficit countries 2/	-2.3	-2.7	-1.0		-1.9	-0.8
Intermediate deficit countries 3/	-0.8	-0.6	-0.7		-0.8	-0.4
Lower deficit countries 4/	-0.5	-0.1	0.4		-0.9	--
Non-EU industrial countries	--	-0.3	0.1		0.1	0.1

1/ Scenario A assumes frontloaded fiscal adjustment in order to satisfy the Maastricht deficit criterion by 1997, and that interest rate premia related to exchange rate risk decline steadily and are eliminated by 1999. Scenario B assumes the same ex-ante adjustment but with no support from declining interest premia. Scenario C assumes that fiscal consolidation in the higher deficit countries and in Portugal is spread over two additional years to achieve the deficit reference value by 1999. Interest rate premia in those countries are eliminated by 2001.

2/ Austria, Greece, Italy, Spain, and Sweden.

3/ Belgium, France, Germany, Portugal, and United Kingdom.

4/ Denmark, Finland, Ireland, and the Netherlands.

Portugal, Spain, and Sweden (see Chart 6). ^{1/} Arbitrarily, fiscal convergence is spread evenly over 4 years, with the credibility gains fully realized only by the year 2001. For all of these countries, the exchange rate is held stable from 1998, but allowed to fluctuate before that. Not surprisingly, the initial contractionary effect of the fiscal convergence is significantly smaller for the countries in question than in Scenario A—and not noticeable over a two-year period. The 5-year output growth rate is also a little smaller for the higher deficit countries, but there is no effect for the EU as a whole. Inflation performance, however, is worse than in Scenario A.

The scenarios can only be illustrative in terms of how they model interest rate premia. Nevertheless, a number of broad conclusions are suggested. First, if credible, a fast pace of fiscal adjustment would not seem to pose major risks for the average pace of growth in Europe over 1996-97. The contractionary effect could be significantly sharper in 1996, especially in the higher deficit countries. However, the results are sensitive to the specific assumptions on the degree to which front-loading of fiscal adjustment is needed and the speed with which interest premia decline. Moreover, to the extent that the current slowdown reflects weakened confidence in economic policies in some countries, the short-term risks may be less than suggested in Scenario A. Second, if a goal of fast adjustment is not supported by fiscal measures which have long-term credibility, the short-run output costs could be more worrisome. Third, for countries unable to muster the political support for faster adjustment, credible policies oriented toward slower adjustment can still bring important benefits. However, there are a number of reservations concerning this latter strategy. For countries that do not have a strong track record in adjustment, it may not be easy for a government to convince markets of its commitment to consolidation over the extended period; without this credibility, the fall in interest rate premia on which the favorable results depend may be slower to emerge. In addition, there would be a less satisfactory inflation outcome for the high-deficit countries than under fast adjustment.

An important feature of the way financial markets are modeled in the Scenarios, is that there is no provision for overall confidence effects from a successful EMU process—whose benefits would accrue to all countries not just those with high premia—or for liquidity effects from a large market for Euro paper. As a result, in Scenario A, the countries with greatest existing credibility do not see a decline in real interest rates compared with the baseline, because of endogenous shifts in portfolios toward the countries with improved credibility. The staff at the European Commission argued that significant reductions in real interest rates would be seen for all countries under the credible adjustment process. They also envisaged that, in the baseline, interest rate premia in nonconvergent countries would rise from their current levels, as a result of their failure to take action, and would not remain unchanged as assumed in the staff's baseline scenario. For both these reasons, they argued that the staff's scenarios overestimated the short-term costs of credible convergence efforts and underestimated the medium-term benefits. A second feature of Scenario A is that exchange rates are assumed unchanged. However, it would be expected that for countries with weak credibility, the confidence boost from a credible adjustment strategy would result in an appreciation of their exchange rates, thereby weakening output growth somewhat in these countries but strengthening it in the other countries.

^{1/} Austria is not included in this group as it has maintained a virtually fixed exchange rate against the deutsche mark for a considerable period. Moreover, the credibility of this policy has not been questioned by the markets.

b. Exchange rate and monetary policy

The EU institutions have not taken a high profile over the past two years in their advice on monetary and exchange rate policies. In deference to the role assigned to the EMI, the Council in its broad economic policy guidelines has steered clear of country-specific commentary on monetary policies, limiting itself to general advocacy of stability oriented monetary policies and stressing the need to reduce inflation to a range of 2-3 percent by 1996 as a step toward price stability. Thus far, the EMI itself also has chosen to play a low-key role in attempting formally to coordinate monetary policies in EU member states. ^{1/} This reflects the heavy demands on the EMI's resources in making the technical preparations for Stage 3 and also that central banks see the EMI as having relatively narrow functions with respect to policies in Stage 2. Moreover, the EU institutions see the task of achieving further convergence in inflation and interest rates as reflecting a need for additional fiscal consolidation and greater policy credibility generally, rather than for monetary policy measures. Thus, in its annual report for 1994, issued in April 1995, the EMI considered the monetary policy objectives of EU countries for 1995 as broadly appropriate. While there are no major incompatibilities seen in the monetary policies of EU countries, concerns have been voiced by the Commission and the EMI about tensions in the exchange markets that have their sources in fiscal and structural policy incompatibilities and/or political uncertainties.

This latter consideration is pertinent to the question of ERM membership for countries not presently participating (Finland, Greece, Italy, Sweden, and the United Kingdom). In its broad economic policy guidelines, the Council, while stressing the need to see exchange rates as a matter of common concern, has not taken a position on ERM (re)entry of countries not currently participating. The key concern here, no doubt, is that countries should not (re)enter the ERM until the policy fundamentals, and fiscal policy especially, are in place that would support participation in an exchange rate arrangement based on fixed central rates. In particular, the creation of those fundamentals would be expected to produce significant nominal and real exchange rate appreciations for some countries, which desirably should take place before a central rate is established. Alternatively, entering the ERM with major policy uncertainties persisting could set the stage for periods of turbulence which would be inimical to both the country itself and its partners; as demonstrated by the experience of Spain in the spring of 1995, 15 percent margins are not an effective bulwark against speculators when fundamentals are perceived as inconsistent with market rates.

The picture in this area varies somewhat among the five EU countries not currently participating in the ERM. The U.K. authorities have stated clearly that they do not wish to reenter the ERM. For Greece, Italy, and Sweden, the adjustment process needs to be further advanced before the country could be seen as ready to (re)enter the ERM. In September 1995, the Executive Board took the view that Finland could consider joining the ERM and, in October 1995, in assessing Finland's convergence program, the EU's Council saw the prospects for exchange market stability as good.

A question related to the exchange rate arrangement is whether countries might use monetary policy to help offset the demand dampening effects of fiscal consolidation. The staffs of the Commission and the EMI noted that, where fiscal adjustment is credible to the markets, it should in

^{1/} De facto, coordination around the central role of the deutsche mark has strengthened significantly in recent months, as reflected in several joint interest rate movements.

itself produce significant support to the adjustment process through reduced interest rate premia, especially since countries with the largest adjustment needs also tend to have large premia. Where the markets are slow to accept the adjustment intentions of fiscal authorities, attempts to delink monetary policy temporarily from the deutsche mark, even if only to use the fluctuation margins to a larger extent, could well be misinterpreted—and poorly tolerated—by the markets, especially where the link to the deutsche mark had been made a central feature of the policy strategy. These views are broadly consistent with those of the staff. The key issue in this area is the extent to which monetary policy in Europe as a whole should support the adjustment process. The recent slowing of economic growth in the EU, which is less pronounced in the high-deficit countries, together with the continued good price performance and prospects, suggests that a further easing of monetary policy may be consistent with the needs of EU countries generally.

c. Labor market policy

Flexibility in labor markets has long been seen as a particularly critical factor in judging a country's suitability for a monetary union in an environment in which asymmetric shocks can occur, and especially in the absence of significant labor mobility. Without sufficient labor market flexibility—in particular, in the face of nominal rigidities—the exchange rate may offer a useful additional instrument to policymakers. Narrowly conceived, rigidities in the labor market may be seen more as a problem for the individual country than as a threat to a monetary union, provided that the framework for monetary and fiscal policies in the union ensures sufficient discipline in macroeconomic policies. This is presumably the reason that convergence in labor market performance was not seen as a necessary component of the Maastricht Treaty. Some argue, however, that the treaty may have underestimated the problems posed for the monetary union, as labor market inflexibility can transform regional shocks into persistent regional structural problems, and this may result in pressure on the monetary and fiscal authorities to loosen the reins on macroeconomic policies.

Independent of the issues in the last paragraph, which relate to the conduct of policy once the monetary union has been established, high unemployment and structural rigidities in the labor markets may exacerbate uncertainties and thereby contribute to market turbulence in the transition to a single currency. First, labor market conditions can affect the credibility of fiscal consolidation plans as markets may question the willingness of authorities to enact strict demand policies, when unemployment is high. Second, labor market imbalances may increase uncertainties on the course of exchange rates in the period up to Stage 3. Among countries that will participate initially in Stage 3, those with serious unemployment problems may be seen as more likely to want their exchange rates to depreciate in the final part of Stage 2; for countries not participating, unaddressed labor market problems could spark speculation on the future parity with the Euro. Third, labor market inflexibility makes it more difficult for macroeconomic policies to promote the convergence in cost developments that is essential for stability in the exchange markets. Finally, it is possible that difficult labor market conditions could incite speculation on whether a country might leave the currency union; the threat may be greatest in the early part of Stage 3, before national currencies are withdrawn. In considering these various points, one should not overestimate the speed with which reforms can produce improvements in labor market conditions and operation. However, appropriate measures, if timed and implemented in a manner that does not produce political and social disruption, can boost confidence in the overall credibility of the policy strategy, and will certainly lay a stronger foundation for Stage 3 itself.

While labor market problems have not been addressed specifically within the context of preparations for EMU, they have been seen as an increasingly urgent issue in EU surveillance, with unemployment rising to 11½ percent in 1994 and only receding a little since then. There is a broad element of commonality in the diagnosis of labor market problems by the Fund and the EU institutions. In particular, labor costs are seen as too high for the unskilled and for those whose skills are no longer in demand in the marketplace, and there is judged to be excessive regulation in the labor market that, inter alia, reduces flexibility in work place arrangements. There is also general recognition that the interaction of social protection and labor market incentives can produce so-called unemployment and poverty traps.

Where the Fund and the EU institutions (the Commission and the Council) have been less in unison is in their recommended response. The EU strategy has focused on strengthening training, providing greater scope for flexibility in work arrangements, improving employment services and, especially, reducing non-wage labor costs (such as social insurance taxes) for the unskilled. None of these is controversial. The question is whether these policies can be employed with sufficient intensity to provide a satisfactory solution to the problem, an important obstacle being the budgetary costs. Given these costs, and also the need to ensure that wage differentials provide adequate incentives to acquire skills, the position taken by the Fund has generally been that labor market problems need to be attacked across a broader front, with the reform of minimum wages and social benefits playing a more prominent role than in the EU strategy.

In the most recent assessments by EU institutions of their employment strategy, there has been increased attention to the need for reform of social benefit systems. Indeed, in December 1995, the European Council declared that among the priorities should be "obtaining the maximum level of efficiency in social protection systems so that, while maintaining where possible the level attained, they never act as a disincentive to seeking work". It is also clear, however, that there remain important concerns in Europe that greater emphasis on market forces might swell the ranks of the working poor.

The Commission sees the EU's employment strategy as capable of addressing the labor market problems in the EU, while at the same time preserving the essential features of the social protection offered by the "European model". In particular, it envisages that the macroeconomic strategy set out in the EU's broad economic policy guidelines, if comprehensively adopted and implemented in a credible fashion, could alone reduce unemployment to 7½ percent by the year 2000. This strategy, which entails a close-to-balanced fiscal position by the end of the century, together with real wages increasing more slowly than productivity and improved policy credibility, would underpin an investment boom and a marked pick up in the growth of output and of potential. ^{1/} Structural measures comprising a cut in social security taxes for the unskilled of 1 percentage point of GDP, financed by an energy tax, and greater scope for part-time employment, could reduce unemployment further to 5 percent by 2000. The staff questions whether one can count on such an

^{1/} European Commission, *The European Employment Strategy: Recent Progress and Prospects for the Future*, October 1995.

optimistic path for wages and investment. 1/ As regards the structural measures, a key question is whether the budgetary resources can be marshalled to finance the reduced non-wage costs. 2/

2. Management of the EMU process

The EU's goals in pursuing monetary union are that the potential benefits of a single currency be achieved in a timely manner, that participation be as wide as possible so as to maximize these benefits, and that the quality of the monetary union be supported through qualification criteria and appropriate constraints on macroeconomic policies within the union. It is evident that some trade-offs will need to be made as it is not likely to be possible to achieve a monetary union by 1999 that is based on a strict implementation of the qualification criteria, and that has, in addition, a very wide participation of EU states. There seems to be a broad acceptance in the EU that it is the latter goal that in the short run will need to be relaxed. It is generally believed that postponing a monetary union beyond 1999 could entail serious risks both for the process as a whole and by relaxing convergence pressure on EU member states. There is also concern that weakening the convergence criteria could affect the credibility of the ECB. Attempts to weaken the convergence criteria could, moreover, threaten the political support for monetary union in a number of countries. Thus, the EU's goal has become, at present, one of maximizing the number of participating countries subject to the constraints on timing and qualification criteria.

The scenarios presented earlier illustrated the critical role of credibility in ensuring of a successful transition to Stage 3; lack of confidence may be a self-fulfilling prophecy, as persistent high interest rate premia impede the adjustment process. This powerful role for confidence highlights the need for EU countries and institutions to contribute to building public confidence. Much of the burden of ensuring that countries are ready to participate in Stage 3 and that the transition path is smooth falls on the countries themselves. However, it is also critical that countries demonstrate their commitment to the success of EMU in the way they work together. Certainly, this requires avoiding public misunderstandings. More generally, it is important to move ahead expeditiously with the preparations, building on the important progress of the past year. This will reinforce the growing belief that the process is getting back on track after the 1992-93 recession and periods of turmoil in European foreign exchanges. It would also counter the skepticism about the commitment to the process that had been generated in the eyes of some by the long transition between the decision on Stage 3 and the disappearance of national currencies.

There are three areas relating to institutional arrangements where early agreements could have significant benefits: the conduct of monetary policy once the ECB is established, the exchange rate arrangements for countries not participating in Stage 3, and procedures for surveillance in Stage 3. In the first area, the question, which has received limited attention to date, is how the transition between the independent monetary policies of Stage 2 and the common monetary policy of Stage 3 will be effected. The realization that there will be a period of about a year between the decision on which countries will move to Stage 3 and the locking of exchange rates, has heightened

1/ The Commission staff argues that similarly virtuous macroeconomic developments occurred in the second half of the 1980's.

2/ If an energy tax were not used, the desired reduction in non-wage costs would probably need to be financed through expenditure cuts to have the employment effects desired, as the incidence effects of alternative revenue sources are likely to be less employment friendly than those of an energy tax.

concerns about exchange market tensions during this time. These worries have been countered by the view that, where economies are well prepared for Stage 3, with balanced policies and an exchange rate that has been stable for at least two years, there should be no doubt as to what the appropriate parity is. However, it is clear from the experience of recent years that markets can see ground for speculation in economic conditions, the concerns of policy makers, and the political cycle, even where parities are not judged out of line. It is difficult to conceive of a fully credible support mechanism for currencies to counter such speculation that would not, in effect, entail strong symmetric intervention commitments. Indeed, once a decision has been made to move forward with Stage 3, the absence of agreement on the support of currencies could be interpreted as an implicit acknowledgement that there may be need for a realignment (or, in the eyes of the more cynical, that the Stage 3 decision is not final), which could in itself help fuel pressures in the markets. A strong symmetric intervention commitment would in effect mean that monetary policies were being coordinated ex post to sustain a particular pattern of exchange rates. There would also seem to be a case for greater ex-ante coordination of monetary policies and their implementation, once the ECB has decided on an operating framework for Stage 3, so as to smooth the changes in how monetary policy is implemented as countries move to Stage 3.

Deliberations are already under way with regard to the second area noted above, the exchange rate arrangements for currencies not participating in Stage 3. A key issue is the extent to which the ECB will be obligated to intervene in support of these currencies. As regards countries wishing to participate in Stage 3, who are not initially eligible but are quite close to qualifying, the central question is how tight a relationship with the Euro should be arranged. The prospect of a tight exchange rate anchor after the beginning of Stage 3 could facilitate the convergence process, as markets would have the knowledge that even if the ambitions of convergence programs were not fully met by 1997, there would be a framework that would continue to foster strict policy discipline. Provided the adjustment intentions of the countries concerned had sufficient credibility, this could advance the reduction in interest rate premia. A related consideration is that a close relationship with the single currency could help alleviate disappointment in countries not participating initially in Stage 3, and would underline that participation would not be long delayed, thus advancing some of the benefits of the single currency also on this score.

There are a number of factors that might suggest a return to an ERM narrow-band type arrangement (or, in the opinion of some, perhaps an even tighter arrangement such as a unilateral peg). The countries concerned would have attained already a considerable degree of convergence; there would be fewer potential incompatibilities in tying to a monetary policy oriented at a range of EU countries than for one directed at Germany alone; and the political difficulty in tying to one country's monetary policy would not be present in the case of the Euro. Nevertheless, as noted earlier, market tensions can still arise in circumstances where convergence is relatively strong, posing the question of the intervention obligations of the ECB if a tight arrangement is opted for. On the one hand, there may be concerns that placing compulsory intervention obligations on the new central bank would be unduly burdensome at a time when it is trying to establish its credibility. On the other hand, it might be argued that, if a non participant country is following disciplined policies and its exchange rate with the Euro is a sound one, there should be no threat to the stability of the Euro. Any surge in Euro liquidity as a result of intervention should be temporary, reversed as markets realize that the speculation will not be rewarded.

How to balance these considerations will undoubtedly be an important focus of debate over the next two years. The size and the number of countries that are likely to want to participate in a tight arrangement will be a consideration. If the economic weight of the currencies so associated

with the Euro were to be relatively limited, the complications for the management of the single monetary policy could be relatively contained. One suggestion to facilitate an agreement on intervention is that the obligations of the ECB be conditional on whether economic policies and performance in the non participating country had been following an already agreed upon path. For such a conditional arrangement to work in the face of a sudden market attack, the ECB's assessment of country performance would need to be kept under frequent review.

Another question is the nature of the exchange rate arrangement for any country not close to qualifying for Stage 3. It is evident that overly ambitious goals for the tightness of such an arrangement could well be counterproductive with costs in terms of the effects of measures needed to counteract tensions and of the disruptions to trade that could follow from sharp fluctuations in real exchange rates. Margins thus need to be wide enough not to encourage speculative attacks, but nevertheless sufficiently meaningful to provide a guide to economic agents. An arrangement such as the current wide-band ERM may provide an appropriate balancing of these goals. ^{1/} In such an arrangement, it would be important for countries continuing to have somewhat divergent inflation performance not to let price and cost discrepancies result in large misalignments of central rates. For these countries especially, the role of fiscal and structural policies in fostering convergence will be particularly important.

Turning to the third area of institutional arrangements, early agreement on procedures for surveillance in Stage 3 could impart additional confidence in the process, not least by reducing potential opposition of those who are concerned that the treaty does not provide sufficient discipline in Stage 3. The broad direction that the discussions have been taking in terms of the goals of such an agreement seems appropriate, as it has always been the intention that the 3 percent of GDP reference value for the deficit constitute an upper ceiling and not a target. Indeed, in 1993, the EU agreed on the medium-term goal as part of the broad economic policy guidelines, that general government financial positions be close to balance. The challenge in the discussions ahead will be to provide the Stage 3 surveillance process with credible enforcement procedures that provide sufficient flexibility to address exceptional circumstances.

One advantage of a strong fiscal surveillance mechanism for Stage 3 is that it could allow more room for the exercise of the judgmental factors in the convergence criteria, without undermining the principle of strict qualifications for entry into Stage 3. In particular, to the extent that it provides assurances that participants in the monetary union would be fully committed to prudent policies, an agreement on surveillance of fiscal policies in Stage 3 would seem to weaken the relevance of the debt criterion. If deficits in Stage 3 are constrained to average well below 3 percent, a sustained decline in the debt ratio for high debt countries would be assured, given the expected growth in nominal income. Indeed one might go as far as to say that if a country satisfied the 3 percent deficit criterion at the time of the decision on the start of Stage 3, the debt ratio could be judged to be sufficiently diminishing and approaching the reference value at a satisfactory pace. Whether or not one goes this far, there would seem to be a case for announcing a liberal interpretation of the debt criterion, if a strong agreement on Stage 3 surveillance is reached.

^{1/} Indeed, to the extent that it is not possible to put in place the institutional requirements for a tight arrangement for the highly convergent countries, the current wide band may be an appropriate solution for all non-participating countries.

A second area where some clarification of the treaty's criteria might assist, without weakening the intent of the treaty, is the exchange rate. The criterion on ERM membership has lost much of its guidance quality since the summer of 1993 and there would be obvious difficulties in rationalizing the exclusion of a country, otherwise well prepared for monetary union, on the basis of non membership in the ERM. A strong agreement on Stage 3 surveillance could provide a solid basis for a re-examination of the exchange rate criterion, as the role of this criterion as a barometer of the market's assessment of the quality and continuity of economic policies would be less necessary. There would remain the difficulty that large movements in exchange rates prior to the start of Stage 3 could raise questions as to the appropriate levels at which to lock exchange rates, suggesting that some evaluation of exchange rate behavior would be needed. If the exchange rate behavior were not to affect eligibility, judgements would need to be made on where exchange rates should be locked and how these rates could be assured in the markets on the last day of Stage 2.

If there is sufficient clarity on these elements of the convergence requirements at an early stage, markets may be more willing to advance the beneficial effects for interest rate premia to countries that put in place credible adjustment measures. By reducing uncertainties in the process and limiting the criteria that need to be observed, some potential tensions on the road to Stage 3 could be avoided and the number of countries qualifying for initial participation in Stage 3 may well increase.

Concerning the number of participants in Stage 3, it is generally held in Europe that the monetary union would need to start with a minimum of five or six countries, including both France and Germany. A larger number of participants is desirable and seems well within reach given the adjustment challenges illustrated in Chart 6. However, the recent slowing of EU economies has increased the size of the adjustment needed to satisfy the Maastricht fiscal criterion, and may have made it more difficult to convince markets that a fast adjustment strategy is credible. In this context, questions about the feasibility of the current time frame are likely to increase, especially if prospects emerge of a more protracted slowdown than presently envisaged. There may be increased pressure to reassess priorities among the timing of Stage 3, the number of participants, and the strictness of the qualification criteria. The degree to which deviation may be allowed from a 3 percent deficit ratio will be a central issue.

If on account of economic circumstances over the next few years, it is not possible for Stage 3 to commence at the beginning of 1999, it will be essential that the process not be abandoned. Rather, in such circumstances, the EU countries should make clear in their agreements and in their actions that only a short delay is envisaged. In support of this, there will be a need to ensure strict budgetary discipline, and the coordination of monetary policies should be strengthened with a view to discouraging potential market tensions.

IV: Concluding Remarks

This paper has addressed a range of policy issues in relation to preparations for Stage 3 of EMU. It is clear that there are difficult challenges to be faced over the next few years, challenges that are being further complicated by the current economic slowdown in the EU. In assessing these challenges and the options for dealing with them, it is essential to see the process in its wider setting.

In the context of the EU countries themselves, there are three important points. First, the commitment to monetary union is part of a broader political process directed at strengthening ties between and cooperation among countries. If the project falters, despite the large investment of political capital, not only would it be difficult to muster political support to relaunch the effort for a considerable period, there may also be a chilling effect on other major initiatives. Second, economic integration has been a cornerstone of rising prosperity in the EU. The single currency is seen as the crowning element of this process and an important—to some, an essential—complement to a single market for goods and services. There are fears that in the absence of monetary union, or with a monetary union only among a small subset of EU countries, currency turbulence and fluctuations in real exchange rates could impede full realization of the potential benefits of the internal market and possibly also give rise to concerns about competitive depreciations. Third, the convergence requirements to qualify for Stage 3 have played a central role in disciplining fiscal policies in many EU countries in the 1990s, much more than the ERM exchange rate commitments did in the 1980s; a stability-oriented single monetary policy combined with a strong surveillance of fiscal policies in Stage 3 would ensure even greater discipline. Without the treaty's requirements, it is doubtful if as much progress in convergence could have been realized to date, and an unwinding of plans for monetary union would raise questions about the permanence of this progress.

As regards countries outside the EU, there are also a number of important considerations. First, the elimination of the potential for intra-EU exchange rate turbulence together with sustained discipline in macroeconomic policies would have important benefits in contributing to a more stable international monetary system. Second, EU membership is an important lodestar for many transition economies in Europe. The success of integration efforts in the EU provides strong incentive for structural reforms in these economies in order to ready them to qualify for membership. Third, the single currency should foster further broadening and deepening of European financial markets, which should provide increased opportunities for borrowers and investors in the world as a whole.

Against this background, the rest of this section reviews the main points in the paper related to the role of economic policies and the design of the EMU process and then notes some considerations for the role of the Fund.

1. The role of economic policies

a. A central question is the pace of fiscal adjustment. The scenarios in Section III.1.a suggest that a policy of rapid fiscal convergence, if credible to the markets, would bring significant medium-term benefits. While there would be short-term adjustment costs in the countries with high deficits, the EU-wide impact, and that on other industrial countries, would be relatively limited. Such a strategy is clearly preferable to an adjustment strategy not supported by credible policies. A more difficult comparison is with a slower, perhaps politically more feasible adjustment in high-deficit countries, *assuming this can be made credible to the markets*. Slower, but still credible, adjustment would result in more moderate short-term output costs and have relatively small medium-term growth costs compared with fast adjustment. However, it would result in a more limited decline in inflation in the high-deficit countries. Thus, the medium-term combination of growth and inflation is superior under fast adjustment. A slower adjustment strategy would also entail delaying Stage 3 eligibility for the countries concerned.

b. A key uncertainty relates to the macroeconomic outlook in the EU over the next few years. In particular, a significant and protracted slowdown could have an important effect on the

size of the adjustments needed to meet the Maastricht fiscal convergence criterion by 1997 and the credibility of adjustment strategies oriented to this goal. An important question is the role monetary policies can play in supporting the adjustment process. The staff considers that, in individual countries with significant adjustment needs, there is only limited scope for discretionary monetary policy to offset fiscal tightening; credible policies would bring with them an easing of monetary conditions as interest rate premia fell, but the markets would be unlikely to tolerate efforts to force significant interest rate reductions. However, with the economic slowing particularly marked in the "core" economies which generally have more limited adjustment needs, there could be a complementarity of needs across the EU favoring a further general reduction of short-term interest rates. Moreover, for the "core" countries, there would seem to be a good case not to expect that they put in place additional measures to offset the effects of slower growth on the overall fiscal deficit.

c. There are concerns about the potential for market tensions in the transition to Stage 3. Appropriate fiscal policies are one element of fostering a smooth transition in the markets. The paper argues that labor market reforms aimed at reducing structural rigidities, while crucial for Stage 3, may also bolster the credibility of the overall policy strategy in the transition. However, these should be timed and implemented in a manner that does not result in political and social disruption that would endanger the process.

2. The design and evolution of the EMU process

a. The emphasis presently in the EU is on getting Stage 3 started in a timely fashion and based on a strict interpretation of the convergence criteria so as to provide a strong foundation for the credibility of the ECB. The number of participants should be as large as can be achieved within this constraint, but this is seen as a lower priority, provided a minimum threshold of five or six countries qualify and are willing to participate (including France and Germany). There are important questions, however, about the problems in managing exchange rates in the EU and the implications for the single market of only a small initial participation in Stage 3. Thus, the recent slowing of the EU economy, which increases the chance that only a relatively small number of countries will qualify, is intensifying pressure for a reevaluation of the relative priorities assigned to the start date for Stage 3, the strictness with which the qualification criteria are applied, and the number of countries qualifying.

b. The paper argues that early agreement on a number of institutional questions could play an important role both by building confidence in the EMU process (reinforcing the momentum that has emerged over the past year), and by reducing the potential for market tensions and uncertainties concerning the status of individual countries. In this context particular emphasis is placed on: strengthening intervention commitments to support the exchange rates of countries that are selected to participate in Stage 3 in the period after the decision to move ahead is made; agreeing on the arrangements for linking non participating currencies to the Euro; and establishing strong fiscal surveillance procedures for Stage 3.

c. The paper observes that there is considerable uncertainty as to how some of the treaty's convergence criteria should be interpreted. Particular attention has focused on the provisions related to government debt and the exchange rate, whose importance would seem to be lessened in the face of a prospective agreement on strong Stage 3 surveillance of fiscal policies. There is also a view that the exchange rate criterion has lost its relevance in a system with wide intervention margins. Clarification of these requirements may have the merit of allowing markets

more easily to judge the convergence status of countries and thereby to avoid tensions related to changing sentiments on interpretation. Against these considerations is the concern that any appearance of loosening the criteria by which countries will be assessed would have adverse effects on the initial credibility of the ECB and would also erode support for the process in some countries. Moreover, specifying an explicit interpretation of the exchange rate criterion could incite speculation to test the commitment of national authorities.

3. The role of the Fund

a. The strengthened surveillance by EU institutions has brought with it a greater overlap in Fund and EU surveillance. There has been much similarity in the advice to EU countries in the surveillance of the Fund and the EU, but there have been some divergences with respect to the strategy in the labor market. The potential for market tension en route to Stage 3 presents an important challenge for Fund surveillance of EU countries and raises questions as to what the role of the Fund should be in forestalling such tension and addressing them should they arise. Staffs of the Fund and the EU institutions have been increasing their collaboration in recent years and there is a clear willingness on both sides to continue and intensify this process. Management and the staff will monitor the situation continuously and will alert the authorities and the Executive Board should the risk of tensions rise.

b. The surveillance mandate of the Fund entails, of course, a global perspective on the impact of the EMU process. Two aspects of the present paper are relevant in this connection. First, the assessment of the macroeconomic impact of fiscal convergence suggests little general impact on countries outside the EU, though of course individual countries with strong economic ties to the EU are likely to be affected to a greater extent. Second, the goal of minimizing tensions in the financial markets emphasized in the paper has clear importance for non-EU countries, not least those whose financial markets are closely tied to the EU, including countries who currently link their exchange rates to individual EU currencies (e.g., participants in the CFA franc zone). Countries in the latter category also will, of course, need to review their institutional arrangements as Stage 3 approaches. Other issues will assume growing importance in the coming years, including the role of the Euro in the international monetary system and international capital markets. There also will be issues related to the work of the Fund, including relations with the ECB and the organization of Fund surveillance work when the single monetary policy commences.

V. Topics for Discussion

1. Concerning economic policies, Directors may wish to comment on:

The relative merits of slower and faster paced adjustment paths for the higher-deficit countries. In this connection, they may wish to consider how the commitment to adjustment could be made credible to the markets, especially in the case of a slower adjustment path.

How they see the current uncertainties in the economic outlook in Europe affecting the desired adjustment strategy.

- The contribution the policy mix in the "core" countries can make to a smoother process.

- ▶ How they see the priorities in national policies in order to limit uncertainties in the financial markets.

2. Concerning the EMU process itself, Directors may wish to comment on:

- ▶ How they evaluate the trade-offs between a timely start to Stage 3, the strictness of the eligibility criteria, and the number of countries initially qualifying to participate. How might this assessment be affected by a significant and protracted slowing of economic growth in the EU?
- ▶ Whether they see the need for stronger provisions concerning intervention obligations and the coordination of monetary policies among participating countries after a decision to move forward with Stage 3.
- ▶ The nature of the exchange rate arrangements linking EU countries not participating in Stage 3 with the Euro. Do they see a need to differentiate between countries that are close to qualifying for Stage 3 and other countries?
- ▶ The need for tighter surveillance of fiscal policies in Stage 3 than provided by the treaty.
- ▶ The effects of uncertainties in the interpretation of the treaty. How do they assess the scope for clarifying the debt and exchange rate provisions of the treaty in ways that might facilitate the transition to Stage 3, but without weakening—or appearing to weaken—the qualification criteria? Do Directors see ERM membership and a stable exchange rate as important indicators of readiness for monetary union?

3. Concerning the role of the Fund, Directors may wish to comment on:

- ▶ How they see the role of Fund surveillance of EU countries over the coming years as the decision date on Stage 3 approaches. Besides close monitoring and surveillance, what other role do they see the Fund playing in trying to avoid market tensions and in addressing them should they arise?
- ▶ The scope and format of Board discussions on EU issues. In preparing papers for the Executive Board, the staff plans to focus on specific topics, such as EMU or trade and trade-related policies, rather than encompass the full range of EU-related topics at one time. Do Directors agree with this approach?
- ▶ The Fund's responsibilities in connection with the impact of the EMU process on countries outside the EU.

