

The Transition To European Monetary Union: New Agreements Are Essential

There is a strong political momentum for European Monetary Union (EMU) to be launched by 1999 on the initial basis of a small 'core' group of countries. In the latest issue of the *Economic Journal*, Professor Michael Artis argues that three conditions are essential to its success: first, making the initial core as large as possible; second, minimizing the waiting time for those countries that do not qualify in 1999; and third, putting in place a mechanism of cooperation between the 'Ins' and the 'Outs' of EMU.

Artis notes that there are two main problems to which these conditions offer a solution. The first is the difficulty that the prospective members are experiencing in meeting the Maastricht convergence criteria for entry into EMU. These require that countries should not exceed certain 'reference values': 3% for the ratio of the budget deficit to GDP; and 60% for the ratio of government debt to GDP.

Opinion-makers in Germany have been insisting on a 'strict interpretation' of the criteria. But the weak growth rates from which most EU countries have been suffering have an automatic tendency to raise budget deficits and debt-to-GDP ratios. At the same time, attempts to reduce spending and raise revenues have deflationary effects in the short to medium term. A scramble to meet the Maastricht criteria in these conditions threatens Europe with a low-level equilibrium as countries export and re-export deflation to one another.

The second problem is the nature of the relationship between those countries in the core of EMU, the Ins, and those outside, the Outs, a potentially dangerous flashpoint for the EU as a whole. The Ins will want to prove that the new currency is a 'hard' one, which almost certainly consigns the currencies of the Outs to 'soft' status. No deliberate policy of 'competitive devaluation' need be entertained to produce a situation where the market forces devaluation of some of the Outs' currencies, leading to demands for some measures of protection by the Ins. In other words, the relationship between the Ins and the Outs could lead to an unravelling of the Single Market.

Artis believes that tackling these two problems demands two new agreements between EU members. The best prospect for obtaining as large an EMU as possible is to obtain a workable 'stability pact' that will govern the behaviour of the Ins. This could take the weight off the entry criteria and hasten the process of transition to a larger EMU. The fundamental inspiration for the Maastricht criteria was the need to ensure that participants in EMU share a like-minded pursuit of stability in economic affairs. The entry criteria can

be regarded as a 'sorting device' to signal which countries satisfy this requirement.

There are two problems with the criteria from this point of view: first, if applied too harshly, the present danger, they will not be revealing and no EMU will be formed. Second, it is always possible for a country to pass the 'entrance test' yet not be truly stability-oriented. A workable stability pact, which must include a range of sanctions on unreasonable behaviour, avoids these problems, providing not an added burden, but a rational basis for taking the weight off the entry criteria.

The second vital ingredient is an exchange rate agreement between the Ins and the Outs. Its essential task would be to preserve the conditions of competitiveness against market pressures on nominal exchange rates. While the system would be expressed in nominal terms, it must be made clear that central rate realignments should be indexed automatically on relative inflation. Although for most countries, this provision might be unimportant, this need not be true for all - even small differences in relative inflation rates accumulate rapidly into substantial differences in comparative costs, if continued for long.

Since the stability of competitiveness is a matter of common interest, it must be expected that exchange market interventions would be two-sided. The control of inflation could be most appropriately undertaken through domestic inflation targeting. These assignments might overburden the policy instruments in the hands of the authorities were it not the case that even the countries most likely to be among the Outs are in most respects already highly convergent.

ENDS

Note for Editors: 'Alternative Transitions to EMU' by Michael J. Artis is published in the July 1996 issue of the Economic Journal. Artis is Professor of Economics at the European University Institute, Florence.

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