The Maastricht agreement on economic and monetary union

This article reviews the main features of the agreement reached by EC governments last December on prospective economic and monetary union in Europe, with particular attention to monetary and financial aspects.

Introduction

The agreement on the draft Treaty on European Union by EC Heads of State or Government at Maastricht last December, which included amendments to the Treaty of Rome on economic and monetary union, marked an important step in the process of European monetary integration that has come to the fore in the past few years. That process was given added momentum by the recommendations of the Delors Committee, accepted at the Madrid Summit in June 1989 as a basis for further work.[1] Stage 1 comprises closer economic and monetary co-operation between member states within the existing institutional framework, aimed at greater convergence of economic performance. It also involves the completion of the Single Market and the strengthening of Community competition policy.

The Strasbourg Summit in December 1989 agreed to hold an early Intergovernmental Conference on EMU, which was convened in December 1990. The IGC held intensive discussions involving finance ministers of all member states, which led to Presidency recommendations last December for Treaty amendments deemed necessary to implement full-scale EMU, with permanently locked exchange rates and a single monetary policy, leading to the adoption of a single currency in due course. The proposed amendments included, in a protocol to the Treaty, a detailed Statute for a European System of Central Banks (ESCB), embracing the existing national central banks and headed by a new monetary institution, the European Central Bank (ECB), based largely on specifications drawn up by the Committee of EC Central Bank Governors. The EMU IGC was accompanied by a parallel conference on political union.

It was agreed at Maastricht that full EMU—known as Stage 3—should begin, for those member states judged eligible to participate, no later than 1 January 1999. But if the Heads of State or Government decide, by qualified majority,[2] on the basis of recommendations by the Finance Ministers' Council (ECOFIN), and after consulting the European Parliament, that a majority of member states fulfil the necessary conditions, they may set an earlier date for the start of Stage 3. Stage 3 could then start as early as 1997, or earlier if the necessary conditions are met. It was also agreed that there should be an early transitional phase—Stage 2—which will reinforce economic convergence beyond Stage 1, including the necessary institutional developments: principally, a European Monetary Institute (EMI), with an advisory and consultative role, taking over the functions of the Committee of Governors of EC Central Banks. It will aim to strengthen the co-ordination of member states' monetary policies, while still leaving ultimate responsibility for policy with national authorities. Stage 2 will also involve technical preparations for Stage 3, and will commence on 1 January 1994.

The British Government played an active part in the IGCs, subject to its general reserve that it could not accept any commitment by the United Kingdom to move to a single currency and monetary policy without a separate decision by government and Parliament at the appropriate time. In the event the Government, while being generally satisfied with the technical arrangements proposed for the next two stages of EMU, and in particular their emphasis on free market principles, did not commit the United Kingdom to joining Stage 3, but instead obtained provisions which allow this country an option to join that Stage, subject to a final decision by government and Parliament nearer the time. This option is contained in a protocol that has the legal force of the Treaty. Denmark also reserved the right, in a separate protocol, not to move automatically to Stage 3. The United Kingdom will participate fully in Stage 2 (assuming ratification of the amended Treaty) and firmly expects to meet the convergence conditions that have been set—which will allow it to move to Stage 3 if Parliament so decides. Because of the convergence criteria (described below), no member state can be certain for several years yet that it will be in Stage 3.

The text of the amended Treaty was completed and signed on 7 February, and will be subject to ratification by member states later this year, which would allow the amended Treaty to come into force on 1 January 1993.

Key features of Stage 3

Stage 3 will start with the irrevocable locking of exchange rates between participating currencies and with the

(1) *Report on Economic and Monetary Union in the European Community*, (1989).

(2) When the Council of the EC acts by qualified majority, members' votes are weighted as follows: France, Germany, Italy and the United Kingdom, 10 each; Spain 8; Belgium, Greece, Netherlands and Portugal, 5 each; Denmark and Ireland, 3 each; and Luxembourg 2. For an act to be adopted on a proposal from the Commission, 54 votes in favour are needed. In other cases, as here, 54 votes cast by at least 8 members are needed.

assumption by the ECB and ESCB of their full powers under the Treaty. They will be responsible for issuing and managing the single currency—the ECU—that will replace national currencies in due course. The basket definition of the ECU will cease to apply when the locking of exchange rates takes place, but the single currency is unlikely to replace national currencies until some time, possibly up to several years, after that. At that time, the national central banks will issue the single currency, subject to ECB authorisation.

The primary objectives and basic tasks of the ESCB and ECB are laid down in Article 105 of the Treaty and Chapter 2 of the ESCB Statute; and the System's structure, operations, governance, and accountability in Articles 106–8 and 109a and b of the Treaty and Chapters III–VI of the Statute.[1] Their primary objective will be to maintain price stability. They will also be required to support the 'general economic policies in the Community', without prejudice to the price stability objective. Their actions will be required to be in accordance with the principles of an open market economy, favouring an efficient allocation of resources.

The ESCB will have as its main tasks the formulation and execution of the single monetary policy, the holding and management of participating member states' official foreign exchange reserves, promotion of the smooth operation of payments systems, and contribution to 'the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system.' This mandate will imply pooling of national responsibility for monetary policy through participation in the Governing Council of the ECB. National central bank governors from participating states will be members of that Council, along with a full time Executive Board appointed by the Heads of State or Government of member states. Members of the Executive Board will have non-renewable eight-year terms. The terms of office of national central bank governors will be at least five years.

No specific *operational* role in prudential supervision is given to the ECB, but the ECOFIN Council will have power to confer specific tasks relating to policies on prudential supervision on the ECB in due course. Such a step would need to be based on a proposal from the Commission, and would require the assent of the European Parliament, and unanimity of all member states in the ECOFIN Council. Furthermore, the ECB and national central banks are empowered to provide clearing and payments facilities, and the ECB will be able to issue regulations on those activities within the Community and with third countries (Statute Article 22). Although the Treaty does not give the ECB an operational role in supervision, the ECB will inevitably be involved in major policy decisions in that area, as in other areas affecting monetary policy, and it would be able to supply liquidity to the banking system through its power 'to conduct credit operations with credit institutions and other market participants, with the lending being based on adequate collateral', subject to its other objectives and responsibilities (Statute Article 18.1, 2nd tiret). National central banks can maintain their existing role in prudential supervision, where they have one.

In the pursuit of their objectives and tasks under the Treaty, the ECB and national central banks are required to be free from all outside interference. Staff of the institutions and members of their decision-making bodies will be required not to seek or take instructions from any outside body, including Community bodies and national governments, and these bodies will undertake not to seek to influence the ECB or national central banks in the performance of their tasks.

Careful thought was given to the question how as powerful an institution as the ECB could be made accountable without detracting unduly from its policy independence. It was recognised that severe organisational and procedural difficulties would be encountered if the ECB were to be made directly accountable to twelve national governments and twelve parliaments individually. Accountability to governments is therefore to be secured through the ECOFIN Council, whose President can participate (but not vote) in meetings of the ECB's Governing Council and submit motions for its consideration; and which may invite the President of the ECB to discuss with it matters relating to ECB tasks and objectives. The ECOFIN Council will also be empowered to amend certain parts of the ESCB Statute, although not those relating to its independence or principal objectives and tasks. The ECB must address an annual report on monetary policy to the European Parliament, the ECOFIN Council, the Commission and the European Council (of Heads of State or Government); and the ECB's President will be required to present the report to the ECOFIN Council and the European Parliament, which may debate it. The ECB President and other members of its Executive Board can be requested to attend hearings of competent committees of the European Parliament. Central bank governors will be free to attend national parliamentary committees in their national capacity or as a representative of the Governing Council of the ECB, although it is possible that they could not be required to do so in the latter capacity.

Another key area of discussion was the allocation of responsibility for external exchange rate policy between the ECOFIN Council and the ECB. It was agreed that responsibility for the choice of exchange rate system (or regime) for the ECU (the single currency) against non-EC currencies in Stage 3, and the central ECU rate within the system, should remain essentially with the ECOFIN Council (Article 109 paragraph 1). It was also agreed that Ministers may, in the absence of a formal system for the exchange rate, 'formulate general orientations' for exchange rate policy *vis-à-vis* non-EC currencies (Article 109, paragraph 2). But the choice of system and central rates would have to be after consultation with the ECB, in an endeavour to reach consensus consistent with the price stability objective; any

(1) Article numbers relate to the texts signed at Maastricht on 7 February 1992.

The main convergence criteria

Four economic criteria for eligibility to join Stage 3 are made explicit in the draft Treaty. These criteria will be used when the Commission and the EMI report to the Council on 'the achievement of a high degree of sustainable convergence' by reference to the individual performance of each member state (Article 109j):

- the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability;
- the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 104c(6);
- the observance of the normal fluctuation margins provided for by the Exchange Rate Mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State;
- the durability of convergence achieved by the Member State and of its participation in the Exchange Rate Mechanism of the European Monetary System being reflected in the long-term interest rate levels.

These are elaborated in the *Protocol on the Convergence Criteria* annexed to the Treaty. There the *inflation* criterion is said to mean that:

- a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed that of at most the three best performing Member States in terms of price stability by more than $1\frac{1}{2}$ percentage points. Inflation shall be measured by means of the consumer price index (CPI) on a comparable basis, taking into account differences in national definitions.

The criterion on the *government budgetary position* means that at the time of examination the Member State is not subject to a Council decision, as referred to in Article 104c of the Treaty, that an excessive deficit exists. Article 104c(2) lays down two criteria for the judgement of budgetary performance:

(a) whether the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value, unless

- either the ratio has declined substantially and continuously and reached a level that comes close to the reference value;
- or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;

(b) whether the ratio of government debt to gross domestic product exceeds a reference value, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

The reference values are specified in the Protocol on the Excessive Deficit Procedure:

- 3% for the ratio of the planned or actual government deficit to gross domestic product at market prices.
- 60% for the ratio of government debt to gross domestic product at market prices.

The criterion on *participation in the ERM* means that:

- a Member State has respected the normal fluctuation margins provided for by the Exchange Rate Mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against any other Member State's currency on its own initiative for the same period.

The criterion on *interest rates* means that:

- observed over a period of one year before the examination a Member State has an average nominal long-term interest rate that does not exceed that of at most the three best performing Member States in terms of price stability by more than 2 percentage points. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions.

Assessments will also make reference to other economic criteria (relating to integration of markets, balances of payments on current account, and 'unit labour costs and other price indices'). Compatibility between national legislation and the Treaty and Statute provisions relating to the independence of the ECB and national central banks will also be examined (Article 109j).

policy orientations would have to be without prejudice to that objective. Only experience can show how these arrangements will turn out in practice, but the agreed provisions clearly require that exchange rate policy is consistent with the non-inflationary monetary policy of EMU, and that the ECB will have a strong consultative role in this process. Day-to-day exchange rate operations will be the responsibility of the ECB, exercised in a manner consistent with the provisions on exchange rate policy. The ECB will be provided with a strategic sum—initially up to ECU 50 billion—of foreign currency reserves for the conduct of exchange-market intervention (Statute Article 30.1).

Some key aspects of the role and operations of the ESCB were left mainly open for later decision. The precise division of labour between the ECB and national central banks in the execution of monetary policy will be for decision nearer the time, but it was agreed that the ECB would 'to the extent deemed possible and appropriate' conduct its operations through the national central banks (Statute Article 12.1, third paragraph), it being accepted that 'the national central banks are an integral part of the ESCB and shall act in accordance with the guidelines and instructions of the ECB' (Statute Article 14.3).

Acceptable solutions were found for several specific UK concerns in Stage 3—for example, agreement to respect as far as possible existing note-issuing practices, which should allow continuation of Scottish and Northern Irish banks' note issues, subject to ECB authorisation; and to respect existing practices in the design of bank-notes, for example, the retention of the Sovereign's portrait on notes issued by the Bank of England.

Fiscal policy provisions

The draft Treaty contains a number of provisions that strengthen the process of fiscal surveillance begun in Stage 1 and introduce constraints in the size of fiscal deficits and their financing. From an early stage there was agreement on the three basic fiscal principles of 'no excessive fiscal deficits', 'no monetary financing' and 'no bailouts', but considerable debate developed about how these should be defined, and how they might be implemented in practice. In the event, agreement was reached on provisions that prohibit the ECB or national central banks from providing credit facilities to government or to Community institutions or other public sector bodies, and from purchasing debt instruments *directly* from them (Article 104). There are also provisions that will prevent the Community and governments of member states assuming the financial commitments of other governments or public authorities in the Community (Article 104b), as a necessary condition for the exercise of effective market discipline on national fiscal policy; and to set up more formal procedures of surveillance over fiscal policy, including numerical triggers designed to prompt a Commission investigation into the fiscal policy of member states (Article 104c). In extreme cases, if the ECOFIN Council concludes that policy is grossly in error, there is provision for sanctions on member states failing to correct excessive deficits, (Article 104c paragraph 11), including the imposition of fines.

Other aspects of macroeconomic policy in Stage 3 were left for decision by national governments, subject only to some extension of the kind of general consultation which is already practised as part of economic surveillance under Stage 1 arrangements.

Key features of Stage 2

Although UK negotiators agreed on the importance of having a clear picture of what a single currency and monetary policy would entail and contributed positively to that aspect, as to others, they also believed that it was important to focus carefully on what should lie immediately beyond Stage 1. They supported approaches to Stage 2 that saw it as a means of reinforcing convergence by all member states towards a sustainable low inflation performance, thus creating the necessary conditions for eventual monetary union at a later date.

The principal new institutional development in Stage 2 will be the creation of the European Monetary Institute to build on the established policy-consultative activities of the EC Governors' Committee, while still leaving responsibility during Stage 2 clearly in national hands, hence avoiding confusion about where responsibility for policy lies and risks that the credibility of the eventual central institution would be damaged. These arrangements are set out in a protocol containing the EMI Statute. The EMI will, among its other key functions, take over the administration of the European Monetary Co-operation Fund and the accompanying financing mechanisms and monitor the running of the EMS, facilitate the use of the private ECU and oversee the development of the ECU clearing system, be consulted by the national authorities on monetary policy and, within the rules set by ECOFIN, on draft legislation in its field of competence, offer opinions and recommendations to them on these matters, and report annually to the Council on convergence and on the preparation of technical procedures for Stage 3, both the latter by December 1996 at the latest (EMI Statute, Articles 4-7). The EMI will also be entitled to act as agent to manage foreign exchange reserves of member states wishing to hold some of them with the new institution. However, the EMI will not intervene in foreign exchange markets on its own account, and members will not be obliged to hold reserves with it.

All EC central bank governors will be members of the Institute, but there will also be a full-time president who will not be simultaneously a governor (EMI Statute, Article 9). It was agreed that in exercising their responsibilities under the EMI Statute, governors should be independent, but that national central banks themselves need not be independent in Stage 2, before the establishment of the ESCB. National central banks should contribute resources sufficient to enable the EMI to meet its administrative costs. The seat of the EMI (and that of the ECB) was left to be decided by

consensus of Heads of State or Government before the end of 1992.

Convergence criteria

The Treaty sets out clear and quantified convergence criteria for participation in Stage 3, relating to inflation, government deficits and debt ratios, interest rate differentials, and ERM participation. The details are given in a box on page 66. Additional factors, including the extent of integration of markets and developments in unit labour costs and other price indices, are also to be taken into account. These criteria probably cannot be applied purely mechanically, but the UK authorities have frequently urged that judgements on convergence must be based on economic grounds.[1]

Assessment of eligibility to participate in Stage 3 will also include an examination of the compatibility between a member state's legislation affecting the status and role of its central bank and the provisions of the Treaty relating to ECB and national central bank independence. Eligibility will therefore imply important changes in the statutory position of central banks in some member states before the commencement of Stage 3.

Transition to Stage 3

The key judgements, both about whether a majority of member states meet the conditions for Stage 3 (if the decision is made in 1996) and about the starting date of that Stage, will be made by the Council meeting in the composition of Heads of State or Government, by qualified majority, acting on reports by the Commission and the EMI, and on the advice of finance ministers and after consultation with the European Parliament. Performance against the convergence criteria will determine which countries may join Stage 3. A majority of member states must be judged to have met the criteria if the decision on commencement is to be taken by 31 December 1996. If a decision to move is not taken then, Stage 3 will start on 1 January 1999; no such majority will be needed then, but whenever the move to Stage 3 occurs only eligible States may join. Those found not eligible will receive a derogation, which will be revoked later if and when a member state is found eligible according to the same criteria.

This raises the possibility that Stage 3 could be formed in 1999 by a smaller group of countries—in theory even as few as two. A reasonable inference would be that, assuming no major unforeseen disruptions, Stage 3 seems fairly likely to begin in January 1999 if not before, although quite possibly with fewer than all the other eleven member states participating (leaving the United Kingdom aside for the moment), and conceivably with less than a majority.

The British Government is fully committed to Stage 2, and the United Kingdom will therefore move to that stage with the rest of the Community (assuming the EMU amendments are ratified). According to the UK Protocol, the United Kingdom would not be required to discontinue overnight (Ways and Means) lending to the Government, unless it moved to Stage 3. Member states are required as appropriate to start the process leading to the independence of the Central Bank. This would not require any action, in the United Kingdom, before a commitment was made to move to Stage 3. The United Kingdom will need to notify the ECOFIN Council of its intention regarding Stage 3 before the end of 1996, depending on the timing of the Council's assessment of convergence. In the event of not joining, it would be able to change its notification and join later, assuming that it satisfied the convergence criteria. The central bank governors of countries not joining Stage 3 would become members of an ECB *General* Council, which would take over the residual functions of the EMI, including in particular the administration of the EMCF and the monitoring of the EMS or a successor exchange rate arrangement governing relations between the single currency and the currencies of member states that do not join Stage 3. It is envisaged that there will be a continuation of arrangements for stabilising exchange rates within the Community in the event that some countries do not join Stage 3.

Conclusion

The Maastricht agreement on EMU was an important step in the process of European monetary integration, and the culmination of twelve months of complex negotiations to which the United Kingdom contributed positively. The agreement, if ratified, commits the other eleven member states of the Community (subject to Denmark's protocol) to moving to full monetary union by January 1999 at the latest, but participation will depend on meeting the convergence criteria. However, no critical mass of eligible countries will be needed to form monetary union then, and even if convergence proves less good than hoped, it seems probable that at least several countries will be able to satisfy the criteria, given the way in which they have been framed.

The British Government took the view that a final assessment of the costs and benefits of a move to a single monetary policy and single currency could not be made until the time of the Council decision on the appropriateness of such a move. The Government, therefore, did not commit the United Kingdom at Maastricht to joining full monetary union, but instead obtained an option to join which may be exercised nearer the time. There will be a need for government and Parliament to come to a decision on that option a little before the end of 1996. In the meantime, the UK authorities fully expect to meet the convergence conditions. Ratification of the Treaty amendments by Parliament would, moreover, commit the United Kingdom to joining Stage 2 when it starts in January 1994, and to playing a full part in that Stage.

(1) A note on convergence in the European Community was published in the August 1991 *Bulletin*; pages 328–31.