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EXCHANGE RATE RELATIONS BETWEEN PARTICIPATING AND NON-PARTICIPATING COUNTRIES IN STAGE THREE OF EMU

Interim report to the European Council

Introduction

1. The process towards the third stage of Economic and Monetary Union is now well underway. Technical preparations have reached an advanced stage, while there is also progress among Member States in achieving a high degree of sustainable convergence. Although efforts are being made to ensure the largest possible participation in EMU from the outset, it cannot be excluded that, at the start of the third stage, a certain number of Member States would not fully participate in the monetary union. Although this is not a desirable situation, one should cater for this eventuality, which also has significance in view of future enlargement of the Union. The Treaty already provides for such a situation, defining the rights and obligations of those countries. However, it does not define the specific nature of the future exchange rate relations between participating and non-participating countries in Stage Three of EMU. Some general orientations need to be defined in order to respond to the request made by the European Council in Cannes.

2. Irrespective of which Member States participate in monetary union, all Member States will continue to share a wide common basis and they are all committed to the general objectives laid down in the Treaty in particular the promotion of a high degree of convergence of economic performance. It is important to reach a clear consensus, early enough, on the general orientations for the future exchange rate relations between participating and non-participating countries. This will contribute to market stability. General orientations should be defined well in advance before the discussion starts on which countries are ready to move to the third stage of EMU, such that final decisions on the specific features of exchange rate relations can be taken once the European Central Bank (ECB) is established, enabling any agreement to be fully operational at the start of stage three.

3. Any framework for exchange rate relations between non-participating countries and EMU countries should aim at: (i) contributing to the convergence process of non-participating Member States, (ii) ensuring the efficient and orderly functioning of the single market through exchange rate stability.

Legal/institutional framework

4. The institutional/legal framework to be applied to the decision on, and implementation of, economic and monetary policies is the same for non-participating countries as for countries in the monetary union, with as main exception rules and procedures related to the single monetary policy. The participating and non-participating countries will therefore generally be subjected to common rules in terms of economic policy making.

5. For Member States with a derogation, non-participation in the monetary union is a transitional phase since they aim towards and they are committed to joining the monetary union as soon as they fulfil the necessary conditions. As future members of the monetary union, they are interested in following as close as possible the path of countries participating in the monetary union.

The current procedures for coordination of general economic policies will continue to apply in the third stage, involving both participating and non-participating Member States. All Member States shall participate in the definition of the broad guidelines for the economic policies of the Member States and of the Community and multilateral surveillance. Furthermore, all Member States[1] will have the legal obligation to avoid excessive government deficits and would continue to be subject to the excessive deficit procedure. Non-participating Member States will therefore participate fully in the economic union

6. The non-participating countries and the EMU countries will have close monetary relations. Their monetary policies will pursue the same objectives and their central banks will be independent[2]. The national central banks (NCBs) of non-participating countries will form part of the European System of Central Banks (ESCB) and their statutes will have to comply with the Treaty[3]. Their Governors will be members of the ECB General Council, which is responsible, *inter alia*, for the monitoring and operational aspects of any exchange rate arrangement in stage three and for the co-ordination of monetary policies between the monetary union and the non-participating countries. Non-participating EU countries shall treat their exchange rate policy as a matter of common interest.

7. The Treaty implies (Articles 109m and 109j(1) and the associated Protocol on the convergence criteria) that as long as there are Member States not participating in the third stage of EMU, an exchange rate relationship between those countries and the participating group will exist. Firstly, Article 109m of the Treaty states that each Member State shall treat its exchange rate policy as a matter of common interest, and the article explicitly refers to the European Monetary System (EMS). Secondly, the convergence criterion on exchange rate stability is defined, both in Article 109j and in the corresponding Protocol, in terms of participation in the exchange rate mechanism (ERM) of the EMS and observance of the normal fluctuation margins, without tensions and without devaluing at its own initiative. The convergence criteria also apply to Member States joining EMU at a later stage. This implies that an exchange rate mechanism must be in existence after the start of stage three as long as there are Member States which do not participate. While the ERM/EMS arrangement is mentioned in the Treaty, this does not necessarily mean that it must retain its current form.

   The expected situation for Member States not participating in EMU with the first group is that they would participate in the ERM at the latest at the start of stage three of EMU. Indeed, that would be the logical consequence of the implementation of their convergence efforts. The three years left before 1999 should allow these countries to reach a stable exchange rate situation resulting from an improved level of convergence and sufficient credibility of their convergence processes.

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1. Only the UK, if it choose not to participate, would not have the legally binding obligation in stage three to avoid excessive deficits. Furthermore, articles 104c(9) and (11) do not apply to the non-participating Member States.

2. The UK is the only exception. The Independence of the Bank of England is not required if and as long as the UK chooses not to participate.

3. As regards the Statutes, see footnote 2.

Situation at the start of stage three

8. Although a certain number of countries may not fulfil the convergence criteria on time for the deadline of 1999, they can be expected to have reached a good level of convergence. This would allow a large measure of exchange rate stability to be reached and to be sustainable. Those countries would be close to joining monetary union. While waiting for it, they would normally be expected to participate in the ERM, whatever its form. The fluctuation margins should provide them enough flexibility to absorb eventual shocks which could adversely affect (at least temporarily) the convergence process.

9. The case of the countries which have the right not to participate in the monetary union unless they decide otherwise (United Kingdom and Denmark), is specific. If they are in a good situation in terms of convergence, their position would be very similar to the one described above for the countries with a derogation, allowing them to participate in the ERM.

10. Non-participating countries could gain credibility in their efforts to reduce inflation by fixing their exchange rate to a stable nominal anchor. Fixing the exchange rate to a large block of nominal stability could provide an anchor for stabilising expectations and facilitate convergence in allowing a lower level of interest rates.

Key features of an exchange rate arrangement in stage three

11. Fostering convergence and preserving the orderly working of the internal market are to be kept in mind when defining the key features of an exchange rate arrangement.

12. Non-participating countries will be committed to the convergence process, since achieving a high degree of convergence is a general objective of the Treaty and the condition for being able to participate in the monetary union at a later stage. In the context of the third stage of EMU, the monetary union will play the leading role in terms of stable economic performance. Therefore, additional efforts towards achieving and maintaining the necessary convergence will mainly have to be made by the non-participating EU countries.

    An exchange rate arrangement can reduce the uncertainty concerning the participation in the monetary union and it can reinforce the credibility of the stability-oriented policies that the country concerned has to apply in order to reach a high degree of convergence. Such an arrangement would reinforce the perception that non-participating countries are not left behind but rather preparing their full participation. This would enhance confidence in their convergence process.

13. Any exchange rate arrangement between the monetary union and non-participating countries should contribute to avoid excessive exchange rate fluctuations between the single currency and the non-participating currencies which would lead to disruptions in trade flows. To this extent, exchange rate stability can be seen as a condition for the internal market to deliver its full potential in terms of efficiency and growth. An exchange rate arrangement which would foster the adoption of stability-oriented policies in non-participating countries, would reinforce their credibility and lead to greater exchange rate stability.

Additional instruments for promoting convergence, consistent with the Treaty and compatible with an exchange rate arrangement, could be considered. In any case, to be successful and to lead to greater stability, an exchange rate arrangement has to be underpinned by a strengthened convergence.

14. The definition of an exchange rate arrangement between the single currency and EU non-participating currencies should take into account the following principles:

- any exchange rate arrangement should provide a framework for the non-participating countries to prepare for their full participation in EMU. Irrespective of the number of participants, EMU should remain open for the others to be able to participate later on;

- the exchange rate arrangement should not disturb markets and should not interfere with the conduct of the single monetary policy. This principle would be particularly important at the beginning of the third stage, when the ECB starts conducting monetary policy. The primary objective of the monetary policy for both groups of countries, price stability, must not be put at risk;

- the exchange rate arrangement needs to be credible and sustainable and it has to be perceived as such by the markets. It has to contribute as well to the conditioning of expectations towards stability. Two necessary conditions for this objective are: (i) an appropriate institutional framework to ensure that the system is able to provide the necessary policy responses, and (ii) the implementation of convergence-oriented policies by the non-participating countries;

- it should be a Community mechanism, i.e. designed and managed within the Community framework. This is based on a number of reasons: (i) the fact that the single currency would be at the centre of the arrangement; (ii) the requirement to treat exchange rate policy of non-participating countries as a matter of common interest; (iii) the fact that non-participating countries are fully involved in the economic union and they are members of the ESCB as well; (iv) the need to support a convergence process leading to full participation in EMU.

Conclusions

15. The Treaty implies that, as long as there are Member States not participating in the third stage of EMU, an exchange rate arrangement between those countries and the participating group will exist. An early agreement on the main features of such an arrangement will help to reduce uncertainty and contribute to market stability. Any exchange rate arrangement should at the same time assist the convergence process and facilitate the efficient functioning of the internal market. In any case, to succeed in stabilising exchange rates an arrangement has to be underpinned by stability oriented domestic policies.