COMMISSION OF THE EUROPEAN COMMUNITIES

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COMMUNICATION FROM THE COMMISSION TO THE COUNCIL

*REINFORCED CONVERGENCE PROCEDURES AND
A NEW EXCHANGE RATE MECHANISM
IN STAGE THREE OF EMU*

1. Introduction

1.1. The Madrid European Council in December 1995 requested that the Ecofin Council, together with the Commission and the European Monetary Institute (EMI) in their respective fields of competence, study the range of issues raised by the fact that some Member States may not initially participate in the Euro area. In particular, issues related to monetary instability were to be examined. Consideration of the relationships between Member States participating in the Euro area (the "ins") and the non-participant Member States (the "pre-ins") has focused on the need for an appropriate and voluntary exchange-rate arrangement between the euro and the remaining national currencies.

1.2. The Ecofin Council first discussed the new exchange rate arrangement at its informal meeting of 12/13 April, 1996 in Verona and progress reports were provided to the Florence European Council on 21/22 June, 1996 by the Ecofin, the EMI and the Commission. Building upon the consensus reached in Florence, the Ecofin Council reached a broad understanding upon the main elements of a new exchange rate mechanism - based on the existing exchange rate mechanism (ERM) - at its informal meeting in Dublin on 20/21 September, 1996.

1.3. The Commission is convinced of the need for a new ERM in stage three so as to provide for the prospect of full participation in the euro area and to protect the single market. The new mechanism will demonstrate monetary solidarity within the Union, while fostering convergence and exchange rate discipline among the "pre-ins". In this context, the Commission welcomes the understanding reached on the main elements of the new mechanism, which may be summarized as follows:

- The new ERM will be composed of bilateral links between the euro and the "pre-in" currencies; this so-called "hub-and-spokes" model will clearly identify the euro as the anchor of the mechanism and will focus on the need to achieve convergence among the "pre-ins" toward the high standard of macro-economic stability in the euro area.

- Central rates and fluctuation margins will be set in a common procedure involving Ministers, Governors of the European Central Bank (ECB) and of the non-participant national central banks (NCBs), and the Commission; fluctuation margins will be wide, while not excluding closer links between the euro and "pre-in" currencies based on progress in convergence and established by the same common procedure;

- Intervention support, with appropriate financing facilities, will be automatically available at the margins but the ECB or relevant NCB will have the right to suspend intervention if its overriding policy objective of price stability is jeopardized; practical ways to limit the fluctuation between the currencies of the "pre-ins" within the standard margins are also envisaged.

- Realignments should be made in a timely manner and by common procedure; all parties involved in the common procedure will have the right to trigger a procedure which might result in a realignment.

2. The role of reinforced convergence procedures in the new ERM

2.1 The Commission notes that the exchange-rate stability enjoyed since Spring 1995 reflects the substantial progress in convergence achieved by all the Member States. The success of these convergence efforts - evident both in terms of decelerating inflation rates and improved budgetary performance - bodes well for the operation of the new ERM. Moreover, the progress in convergence already achieved confirms the Commission's view that the "pre-in" status of any Member State after 1 January, 1999 will be merely transitional. The new ERM should be viewed, therefore, as a framework to support the final steps in convergence among the "pre-ins" ahead of participation in the euro area.

2.2 Experience has shown that exchange rate stability depends more than anything else upon sound macroeconomic management. The quality of macroeconomic management among the "pre-ins" in stage three will be reflected in their steady progress toward achieving a high degree of sustainable convergence. Accordingly, the successful implementation of a credible convergence programme would be expected to minimize the risk of sustained weakness in the exchange rate of a "pre-in". With this in mind, the Commission proposes to reinforce existing convergence procedures for the "pre-ins".

2.3 Given the linkage between exchange rate stability and convergence, the Commission would foresee a role for reinforced convergence programmes in the management of the new ERM. For example, the progress achieved by a "pre-in" toward its convergence objectives might be used as a reference in deciding on the sustainability of central rates. A favourable performance relative to convergence objectives would be expected to strengthen the case for support for a "pre-in" currency in the event of speculative pressures. However, the use of convergence programmes as a reference in the context of the new ERM would not interfere with the ECB's prerogative to safeguard its price stability objective with respect to its intervention obligations. This convergence-based approach to operating the new ERM would preserve flexibility while ensuring an appropriate level of exchange rate discipline. Moreover, as a more "preventive" than "corrective" approach, it also seems well-suited to the needs of the "pre-ins".

3 Reinforced convergence procedures

3.1. With a view to ensuring full participation in the euro area at the earliest possible date, convergence efforts by the "pre-ins" will need to be underpinned in the third stage. In particular, there is already an understanding that the submission of convergence programmes for consideration by the Council should become a formal obligation for the "pre-ins" in parallel with the obligatory stability programmes proposed for the "ins". The Member States concerned would be required to submit new convergence programmes (to replace the existing generation) before the beginning of stage three on 1 January, 1999 with a common structure and information content so as to ensure a comparable standard against which to judge performance.

3.2 Objectives for the inflation rate, the government budget balance and the government debt ratio would be included in the convergence programmes, together with a clearlyspecified multi-annual adjustment path towards these objectives. Prospects for the exchange rate and long-term interest rates would also be considered so as to complete the coverage of the convergence criteria in the Treaty. Measures taken or proposed to achieve the convergence objectives would be described and accompanied by indications of supplementary action in the event of significant slippage. The main economic assumptions underlying the convergence strategy - perhaps including some sensitivity analysis - would be made explicit so that the conditions in which the strategy is likely to be implemented may be understood and their realism assessed.

3.3. The time horizon for new convergence programmes should, in principle, be very short in view of the degree of convergence likely to have already been achieved by the "pre-ins" on 1 January, 1999. Nevertheless, a medium-term focus - in particular, establishing a budget deficit target below 3% of GDP - would seem appropriate, facilitating the conversion of a convergence programme to a stability programme as soon as the relevant "pre-in" qualified for participation in the euro area. Convergence programmes would be updated each year. Updating of programmes would involve a review of the implementation of the programme, confirmation of convergence objectives and the relevant adjustment paths, and, in the event of observed slippage, á description of additional measures to be taken. The macroeconomic assumptions underlying the programme would also be reviewed, with the implications of any revisions to be fully reflected in the convergence strategy.

3.4. Strengthened convergence procedures at the Community level are also envisaged. Notwithstanding the primacy of national responsibility for convergence, the Council and Commission would exploit to the maximum the surveillance procedures provided for under Article 103 of the Treaty. The Council would be required to complete an examination of a convergence programme within two months of its submission and would be given the right to endorse the programme upon a recommendation from the Commission and after consulting the Monetary Committee/Economic and Financial Committee. This would indicate a mutual commitment: a commitment from the "pre-in" Member State to proceed quickly toward the conditions necessary for the adoption of the euro and a commitment from the Union to support the Member State's efforts.

3.5. The implementation of the convergence strategy would be monitored on a regular basis at the Community level. Major slippage from targets would be identified and a recommendation would be made that corrective action be taken by the time of the next update of the programme at the latest. Moreover, the budgetary objectives laid down in the convergence programme would become the basis for establishing recommendations where these are required under the excessive deficit procedure and in assessing compliance with those recommendations.

p.m. The legal basis for reinforced convergence procedures

The legal basis for strengthening the existing convergence procedures would derive from Article 103(5) which allows the Council to "*adopt detailed rules for the multilateral surveillance procedures*". As in the case of ensuring budgetary discipline in stage three, secondary legislation can be adopted with a view to strengthening those aspects of multilateral surveillance relevant to convergence.