THE EUROPEAN MONETARY SYSTEM AND EUROPEAN INTEGRATION: MARRIAGE OR DIVORCE?

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Abstract

This paper presents the various economic approaches to achieving monetary union, particularly in the context of European Economic and Monetary Union (EMU). It also evaluates the implications of the Maastricht Treaty, in the light of the current state of economic convergence and given the economic convergence criteria embodied in the Treaty, in terms of economic policy for individual Member States and for the European Union (EU) as a whole. Comparisons are made with other more mature federations, and a case for greater fiscal federalism post-1999 is presented. The paper concludes by assessing the options for the EU at its scheduled inter-governmental conference in 1996, for amending or replacing the Treaty.

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I. Background and Introduction

The historical origins of European Economic and Monetary Union
(EMIl) are rooted in political concerns arising in the aftermath of the Second World War. The idea of some form of future political union was embedded in the Treaty of Rome (1958), but in its early years the European 'common market' (as the then European Economic Community or EEC was called) developed almost exclusively along economic lines, mostly in the areas of constructing and then maintaining a customs union, and operating a pan-European agricultural policy between its members. The Common Agricultural Policy (CAP) required fairly stable intra-EEC exchange rates to be effective, so member countries adopted narrower fluctuation bands than were required by Bretton Woods. In this period, there was no political consensus on how or whether member countries should seek to develop the customs union into something more substantive. In the early 1970s, as it became clear that the Bretton Woods system was crumbling, attempts were made to encourage new political initiatives aimed at engendering an integration dynamic as part of the acquis of the community.

The Werner Report (1971) [which was the product of the Werner Group set up in 1969], was the earliest attempt to specify a more concrete plan to achieve greater monetary and economic integration between member countries. During the Werner Group negotiations, it became clear [see Tsoulkalis (1977) and De Grauwe (1990)] that two opposing groups had formed with views on strategies to attain EMU. These groups were labelled the 'monetarists' and the `economists', the former holding to the view that early progress in the monetary field would force an effective coordination of economic policies and the latter believed that harmonisation of economic policies should take priority before any coordination of Community monetary policy were embedded in the system. These two groups have characterised much of the debate surrounding integration in more recent discussions surrounding Maastricht.

The stability of the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS) post-1985 inspired confidence among a new generation of European technocrats, and encouraged new plane for European integration. The issuance of the Delors Report in 1989 provided new impetus towards monetary unification in Europe and laid out the basis for the eventual treaty for unification, signed in Maastricht, the Netherlands, in December 1991. The Delors Report was, in essence, a blueprint for a `monetarist' approach (of a gradualist kind) to EMU.

There were two dissenting voices against the means of achieving monetary union, the UK government and the German government (as well as the Bundesbank). The UK government objected to the report on the basis that it ceded monetary sovereignty to a European monetary institution and that it implicitly sought the abolition of national currencies. The UK government issued two documents (HM Treasury (1989) and (1990)) as alternatives to the Delors plan which embodied the Hayekian parellel-currency principle. This approach came to be nown as the "Hard Ecu" plan. The Bundesbank's objections were of an 'economist' nature. The Bundesbank wanted strict criteria to be incorporated into the plan before countries could proceed towards monetary union and the German government also sought greater European political integration so that the European Central Bank could be answerable to a European Parliament that possessed real powers. It became clear that the "Hard Ecu" proposal, whilst it obtained a polite reception, was unacceptable to most of the UK's European partners. At the Inter-Governmental Conference in Maastricht in December of 1991, agreement was reached on a compromise that satisfied the Germans. This consisted of five convergence criteria to be attained before countries could proceed

to monetary union. The UK, still dissatisfied, along with Denmark, which foresaw political problems in making the Treaty palatable to its citizens, negotiated opt-out clauses.

This paper evaluates the different approaches to EMU and evaluates the ramifications of pursuing each approach. Section II looks at the whole process of moving towards EMU and the Maastricht approach. Section III turns to the fiscal policy implications. Section IV takes a critical look at the Maastricht convergence criteria and Section V presents an assessment of the Maastricht approach and evaluates alternatives to Maastricht.

II. The Road to EMU

All 12 States have now successfully ratified the Maastricht Treaty. The process of EMU began with Stage 2 of the Treaty provisions on January 1st, 1994, with the establishment of the European Monetary Institute (EMI).

a) Generic Approaches

There are many possible paths to attaining EMIl. Below several alternative blueprints for a path to EMU are explored:

i) 'Maastricht' approach [Time-specified/Gradualist];
ii) Hayekian "Hard Ecu" approach [Competition/Gradualist]; and
iii) 'Hawaiian' approach [Shock].

The paths can vary according to both speed of transition and route taken to the final objective, however the two are not mutually independent. There are two basic approaches concerning the speed at which a monetary union is adopted, the gradualist approach (which is essentially an approach that has a specified timetable, or agreed upon criteria before the next stage can begin) and the "shock-therapy" or 'Hawaiian' approach to achieving monetary union. The "Hard Ecu" approach is based on contemporaneous currency circulation, and therefore might be considered gradualist, but there is no certainty as to whether the process will actually yield EMU, as the process could conceivably reverse at any point in time. Next, the three approaches are described in more detail.

i) The 'Maastricht' approach

The Maastricht Treaty envisioned one particular route to EMU, which consists of three stages, as follows:

Stage 1 (July 1, 1990 to December 31, 1993) - in this stage, the EMS abolished all remaining capital controls, monetary co-operation between the EC central banks was strengthened and realignments of the ERM were possible;

Stage 2 (January 1, 1994 to between January 1997 and January 1999) - in this stage, the EMI is established as a temporary institution to oversee transition to stage 3, all Member States will start the process leading to the independence of their central banks, the Commission and the EMI will establish whether the Member States achieve or are moving towards achieving certain criteria as specified in the Treaty and ERM realignments will be vigourously resisted; and

Stage 3 (from between January 1997 and January 1999 onwards) - in this stage, the exchange rates between the national currencies will be irrevocably fixed, the European Central Bank (ECB) will start its operations, the ECU will become a currency in its own right and will circulate as the only currency in EU member states that have proceeded to the third stage.

The Maastricht approach was to set entry conditions, the convergence criteria, and to use the ERM as the stepping stone from which to gradually reduce volatility until exchange rates could be fixed, after which a single currency could be substituted.

ii) The Hayekian "Hard Ecu" approach.

The "Hard Ecu" approach is another possible route to EMU. In

this Hayekian approach, the ECU is always devalued or revalued in line with the strongest currency in the EMS. This is basically the "Hard Ecu" approach put forward by the UK. Economic behaviour then determines the speed at which individuals give up their national currencies for the Ecu, and in the meantime, the two currencies circulate alongside each other. Hayek (1976a,b; 1984) argued that national monopolies in money supply should not be supplanted by control of Ecus by a new supra-national monetary institution. The concurrent circulation of currencies, Hayek argued, would produce greater stability and restrain the abilities of individual national monetary authorities to unduly increase their own money supplies. The drawback here is that if national monetary authorities restrain monetary creation, then this evolutionary-competition approach might not lead to the outcome of all national currencies being replaced by the Ecu, so that the "means" might not achieve the "end" as envisaged in the Maastricht Treaty. One of the advantages of this approach, however, would be that criteria for entry into EMU would be unnecessary, so 'economist' concerns would be placated.

iii) The 'Hawaiian' approach

The 'Hawaiian' approach is one of moving directly to EMU in contrast to the gradualist approach. (The Hawaiian secession into the United States occurred in a single step, with appropriate legislation being adopted simultaneously with adoption of the U.S. dollar). Prior to the signing of the Maastricht Treaty, the Hawaiian approach was favoured by several leading European economists (see Giovannini (1990), for example). It is highly unlikely to be feasible in a European context, as the political prerequisites for this approach, as illustrated in Germany in the case of German Economic, Monetary, and Social Union (GEMSU), are draconian. It would therefore be unacceptable to most Member States, and furthermore, it would likely be impractical, as the European institutions to oversee such a transition are insufficiently developed.

The transition to monetary union, as Fratianni, Von Hagen and Waller (1992a) point out, could potentially involve 'end games', in that "participants know that a particular arrangement will stop at a certain time and that they can influence their relative wealth or income positions in the subsequent arrangement by taking certain actions under the current one". An example would be seigniorage distribution - if this distribution in the new regime depended on the relative size of national monetary bases, each government would have an incentive to increase money growth to secure a higher seigniorage share. End games can be discouraged by either keeping the timing of the final transition unspecified or by setting entry conditions. This likely explains why, in practice, the 'Hawaiian' approach has tended to incorporate an element of surprise, as a specified transition date could encourage fiscal profligacy and a distortion of economic behaviour in the period before the currency conversion occurs.

b) The Transition Process

Whatever approach is chosen to get to EMU, there are various questions as to the component parts of the transition process. In this instance, there are five issues that need to be addressed:
i) Should monetary union be accompanied by a further significant increase in economic convergence?;
ii) Should EMU be accompanied by national currency stability?;
iii) Should the EMU process incorporate a role for national central banks, and if so, what should it be?;
iv) Should some form of fiscal federalism be developed in the transition to help Europe's periphery shoulder regional shocks?; and
v) Should EU monetary institutions be developed before EMU eventually occurs, and if so how?

Each of the generic approaches described in the previous section has different responses to these questions, and these are summarised in table i.

TABLE 1

The Transition Process to EMU

	Maastricht	Hard Ecu	Hawaiian
i) Economic convergence?	Yes	No	No
ii) Currency stability?	Yes	No	No
iii) National bank role?	Independent	Yes	None
iv) Fiscal federalism?	Minimal	Yes	(Yes)
v) EU monetary authorities?	EMI	Yes	Yes

In table 1, three specific examples of the three possible approaches to EMU have been given. Maastricht's answer to the role of National central banks is unclear, but central bank independence is a priority and with the degree of fiscal federalism there is a limit of 1.27% of EU GDP (for 1999) in the stipulated projections for the EU budget. The 'Hawaiian' approach does not need any convergence, but requires complete cooperation on the part of the National central banks and also may require some resource transfer depending upon the rate at which the conversion is made. The "Hard Ecu" approach requires no economic convergence or currency stability but for National central banks to play a role in determining the speed at which the transition occurs, and indeed, whether it occurs at all. Some fiscal redistribution may be required for the "Hard Ecu" approach, as regional shocks may endanger the efficacy of national fiscal policies due to the legal ability to substitute national currency for Ecus.

The irony is that to date, the convergence criteria specified in Maastricht will probably not be met by any of the Member States excepting Luxembourg (see De Grauwe and Gros (1991) and Financial Times (1993a, 1994c)), and most member states are operating, if at all, under exceptionally wide fluctuation bands in the ERM (this is unlikely to change following recent evidence EMI President Mr. Lamfalussy gave to the European Parliament (see Financial Times (1994b)). The role of National central banks is a moot point with many European governments (notably the UK and France) and the degree of fiscal federalism as envisaged under the Edinburgh plan has been attacked as inadequate (see Sala-i-Martin and Sachs (1991)). Only the development of EU monetary authorities appears to be on track, with the EMI established as the pre-cursor to the ECB.

c) Currency Stabilisation and the Role of the EMS

The Maastricht Treaty (Council of the European Communities (1992)) specifically states that Member States should observe: "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" (Article 109j, indent 3).

By 'normal', the Treaty implies the +/-2.25% margins in operation at the time that the Treaty was signed (exceptions were made for Italy and for any new participants in the ERM). Although to 'no devaluation over a certain time period' clause is clearly arbitrary, it actually serves little real purpose. The real objective should be to ensure that when the Member State joins EMU, it does so such that its currency is at a sustainable level for the longer term.

The Maastricht formula of enforcing fiscal, monetary and exchange rate criteria may, in certain circumstances, not be entirely compatible, or indeed, consistent with the overall objectives of EMU. For example, consider an economy where the economic variables for the convergence criteria are approaching their appropriate levels. If a transitory shock hits the economy, which in turn causes a lengthening of the expected period of time before entry into stage 3 of EMU was anticipated, this might lead to some turbulence in the foreign exchange markets. Central bank action to offset such turbulence (by increasing interest rates, for example), might only exacerbate the situation in terms of the economic criteria, further altering expectations. Hence, because of the limited room for manoevre in the foreign exchange market, transitory shocks can permanently affect expectations, even when it is known ex-post that they are transitory. As the ERM of the EMS operates around the Ecu, which is itself a weighted basket of the EMS currencies, the room for manoevre with a given transitory shock must be proportionate to the weight the currency has in the Ecu basket.

In a more general sense, though, the use of the ERM of the EMS to achieve EMU is confusing an adjustable-peg exchange rate regime which is very effective when used as an independent volatility-

reducing mechanism, with a criteria-dependent dynamic process to move the EC towards a monetary union. The two are mutually incompatible on many levels.

The potential incompatibility of the ERM objective with the convergence criteria has not been observed in practice to date (partly because the margins of fluctuation are now extremely wide at +/-15%), but a similar event in the recent history of the ERM of the EMS serves to illustrate the point. In the sumner of 1992, first Denmark surprisingly voted not to ratify the Maastricht Treaty (announced on June 3), and then it appeared that France, in particular, would not ratify the Maastricht Treaty in a country-wide referendum. These setbacks, especially if repeated elsewhere, would not render the Maastricht Treaty timetable completely unworkable (although some doubts were expressed by legal experts at the time), but it was widely perceived that this could cause a delay in the EMU process, if not a partial renegotiation of various sections of the Treaty protocols, or at worse a two-speed EMU process. Here, speculative attacks on various currencies occurred (including the French franc), due to increased uncertainty over the French and other referendum outcomes. This probably acted as a transitory shock would have, creating turbulence in the foreign exchange market and large-scale short-term capital flows. These events and proposed explanations for them are chronicled in detail by Eichengreen and Wyplosz (1993).

III. Fiscal Federalism

Fiscal federalism is discussed in a branch of the public finance literature which deals with the assigning of different expenditure and tax/transfer competences to different levels of government (see Oates (1972)). Much of this literature assumes a static economy, so in a sense it is not applicable to EMU. Further, it says little about interregional income redistribution and regional stabilisation, so lacks the ability to deal with the dynamic issue of whether such disparities and asymmetries should be addressed as Member States move towards a more federalist structure. It does, however, have one important implication for EMU, which has been enshrined in Article 3b of the Maastricht Treaty, the principle of subsidiarity.

a) The Subsidiarity Principle

Subsidiarity stipulates that a higher level of government should only assume responsibilities that cannot be taken care of effectively by a lower level of government. Implicit in this principle is a preference for national autonomy in regulation, so coordination, in terms of for example the formation of committees is assumed preferable to harmonisation or centralisation (see Centre for Economic Policy (1991)). Harmonisation is seen as a last resort, once attempts to coordinate policies between Member States has failed. In all federalist structures there is always a tension between subsidiarity and harmonisation. In theoretical economic terms these competences are normally well specified, but in practical terms the line is very grey indeed.

Several questions arise here, notably: what are the reasons for attempting to implement the subsidiarity principle in practice, and to what extent might the principle of subsidiarity confound the attainment and the effects of EMU?

In answer to the question of why the subsidiarity principle should be used as a competence assignment criterion, Courchene et al. (1993) provide three arguments as follows:

i) national differences in needs and tastes;

ii) better democratic control of public services at a national level; and

iii) decentralised supply of public goods and services encourages competition and innovation between national authorities.

The first of these arguments, in the EU context, is certainly not in dispute: it is the European reality. The second reason reflects the notion that decentralised decision-making brings government 'closer to the people' (see Tresch (1981)). The third argument is somewhat controversial, however, as it assumes that a sufficient degree of labour and capital (or corporate) mobility exists between Member States. Certainly, since 1993, the free

movement of labour and capital following the implementation of the single market is possible, but cultural and linguistic differences inevitably inhibit labour mobility and other factors such as natural resource availability constrain the movement of firms between Member States.

Even if the third reason cited above (increased competition between national authorities) for the subsidiarity principle is set aside, the principle could be justified on the basis of the first two reasons. But in what circumstances should competences either be coordinated or passed to a supranational level of government, according to the principle of subsidiarity? In 1977, the MacDougall Report was published (Commission of the European Community (1977)) which "examined the criteria for assigning functions to the different levels of a multi-tier government" (Plender (1991)). The report identified 4 rationales for assigning competences, in addition to that of the principle of subsidiarity. These are:

i) cross-border spill-over effects of national policies that give rise to externalities;

ii) economies of scale and/or indivisibilities in national policies; and

iii) the pursuit of homogeneity and/or fairness.

With spill-over effects, the more integrated economies grow, the greater these spill-over effects are likely to be. For economies of scale and/or indivisibilities, efficiency gains are cited as the benefit. The pursuit of homogeneity and/or fairness (often termed "national standards" in Canada), however, is the most controversial. In terms of the homogeneity argument, this justification has been already caused much debate within Europe following claims that the European Commission has not been following the subsidiarity principle and has initiated directives in areas where it has no competence (for example, sausages, garden implements and beer!).

In terms of the notion of fairness, this brings into play the whole issue of regional disparities, and the fiscal competencies of the EU. This issue is crucial, as it is in this realm that the principle of subsidiarity could conceivably confound EMU.

b) Regional Disparities

The political tension between those gaining and losing in a federalist structure is normally justified by the economic principles of fiscal federalism. The principle here is often called the 'resource flow' principle - that is, the flow of resources should flow from richer to poorer Member States. Hence regional disparities might be expected to diminish in a federalist structure. But the degree of political homogeneity is clearly a factor in the perceived desirability for the extent of 'resource flow', even if such economic benefits in terms of overall welfare improvement could be convincingly demonstrated. The experience of federations such as the USA, Australia and Canada is that language and cultural similarities and factor mobility engender a much greater level of acceptance for 'resource flow' in general and more specifically regional income redistribution. Table 2 details recent estimates regarding inter-regional income redistribution in the US, Canada and Australia.

TABLE 2

Estimates of Competence Specialisation in Selected Federal throuqh A Centralised Budget

Country	Expenditure Centralisation	Revenue Centralisation
USA	76.5%	68.0%
Canada	50.6%	50.3%
Australia	80.4%	74.4%
Switzerland	61.9%	55.6%
Belgium	93.5%	93.1%
Germany	70.0%	61.9%

Notes: i) All figures are for 1988, with the exception of Switzerland, 1984.

ii) 'Expenditure Centralisation' is consolidated

central government expenditure as a proportion of
consolidated central government plus other state
spending: IMF Government Statistics.
iii) 'Revenue Centralisation' is tax revenue and
social security contributions to consolidated central
government relative to total tax and social
security revenue of consolidated governments: IMF
Government Statistics.

In the above table, all mature federations are shown to have a substantial degree of expenditure and revenue centralisation. Most of these countries are unilingual, bilingual, or trilingual at most, which suggests that linguistic and cultural differences might be a major impetus for the acceptability of resource flows, as compared with the EU.

c) Budqetary Fairness and Convergence under Maastricht

As Courchene et al (1993) point out, "there is an inverse relationship between State public finance autonomy and interregional redistribution". This claim directly follows from the fact that the capacity for interregional redistribution depends ceteris paribus on the size of the federal budget relative to the budgets of the Member States. There are, therefore, in any federation, winners (the poorer Member States) and losers (the richer ones) - this is usually referred to in political terms as "fairness in the supra-national budgetary process". In fact, the acrimonious juste retour debate in Europe was triggered by this specific issue in relation to the UK, and although it was corrected with the UK abatement declaration' at the Fontainebleau Summit (1984), the issue of "fairness" in terms of net contribution to the EU is still a major issue in many Member States. In most mature federations "fairness" is also an elusive concept in budgetary politics, as certain expenditures cannot generally be apportioned on a regional basis.

This naturally leads to a discussion of the nature of convergence within a more federal EU structure. Given no interregional income distribution, there are two views here on whether convergence will occur in an economic union - the most well known often being labelled the 'convergence hypothesis'. The convergence hypothesis states that spatial disparities will tend to disappear under an economic union due to international trade, capital flows and labour mobility. The opposing view stresses the existence of imperfect competition, economies of scale and externalities and so asserts that convergence in an economic union will be deflected due to 'cumulative causation' processes (see Prud'homme (1993)). Clearly, even if international trade has no additional effects in the EU, inter-regional income redistributions must be sufficiently large enough to offset any 'cumulative causation' processes for economic convergence to occur.

The whole notion of budgetary fairness is therefore congruent to that of economic convergence. But economic convergence in reality under Maastricht is a moot issue, as the loss of two economic policy levers (monetary and exchange rate policies) leaves only two other levers (national fiscal policies and the EU budge= itself). This could limit national governments when responding to asymmetric shocks and could potentially discourage convergence. The outcome logically depends upon the relative phasing of business cycles between each Member State and the ability of national governments and the European Commission through the EU budget, to respond through fiscal means.

Concerning the role of the EU budget, the medium term evolution of the EU budget was decided by EU leaders at the Edinburgh Summit in 1992. The budget will grow from just under 1.2% of EU GDP to a limit of 1.7% of EU GDP by 1999, coincidental with the last date that stage 3 of EMU can begin. Furthermore, it was decided that the Commission would be denied fiscal sovereignty (the ability to raise taxes independently of national governments) and would continue to raise most of its resources by a 'surcharge' on indirect taxes (VAT) collected by Member States. This is in addition to the legal prohibition from running a deficit and the highly discretionary nature of outlays, with more than 80% being directed to the Common Agricultural Policy or regional development. The inability to raise 'own resources' and to operate inter-personal income transfers, when compared to other more fiscally-sovereign federalist structures, is unique to Europe. This suggests that the reason that the EC budget is so miniscule in comparison with other more mature federations might be because of the political

unacceptability of regional income redistribution and the associated addition of tax competencies to a centralised federal administration.

The fact that there will be little interregional income redistribution in the EC suggests that the ties binding the Member States together will be far less substantial and resilient than for countries in table 2. The reality of this fact spawns a whole series of corollaries, but most poignantly that the Member States will need a great deal of fiscal latitude to deal with regional- or industry-specific disturbances and shocks, given that both monetary sovereignty and the exchange rate instrument will no longer be available to Member States.

It should be noted that one other economic valve for responding to asymmetric shocks, ex post, is through labour migration. As has already been noted, cultural and linguistic differences (as well as inter-regional transfers themselves) tend to inhibit the rate of migration to high growth regions, as has been observed in Canada and Switzerland.

As the EU budget cannot support compensatory redistributive initiatives to alleviate the effects of asymmetric shocks, this leaves, in extremis, national fiscal policies as the only policy lever available.

IV. The Maastricht Convergence Criteria

The Maastricht convergence criteria have a dual purpose. As stage 3 of EMU approaches, economies should maintain a convergent path, not only in a monetary sphere, but also with respect to fiscal policies. Convergence criteria also deflect any concerns that national governments might participate in 'end games'. Convergence criteria, then, are a useful way of facilitating a smooth transition period to EMIl, with explicit objectives, as well as a complementing the increased fixity of exchange rates envisaged for the EMS. The pertinent question is not the desirability of convergence criteria per se, but rather which criteria are relevant, practicable and suitable to reflect convergence of the economic variables that will best ensure the least onerous path to EMU. Any critical assessment of the criteria should pursue this line of inquiry, given that the criteria have already been selected and defined by the Maastricht Treaty.

a) The Criteria

Economic convergence criteria are laid down in the Maastricht Treaty. This is unique to Europe, and is politically a recognitionof the 'economists' approach to monetary union. The criteria are as follows (Article 109j):

i) Price Stability - an annual average rate of inflation that does not exceed by more than 1.5% that of, at most, the three best performing Member States;

ii) Interest Rates - observed over a period of one year, a Member State has had an average nominal long-term interest rate on government bonds that does not exceed by more than 2% that of, at most, the three best performing Member States in terms of price stability;

iii) Government Deficits - the deficit should not exceed 3% for the ratio of the planned or actual government deficit to gross domestic product at market prices; and

iv) Government Debt - the debt should not exceed 60% for the ratio of government debt to gross domestic product at market prices; and

v) ERM - a Member State has respected the "normal" fluctuation margins provided for by the exchange-rate mechanism of the EMS without severe tensions for at least the last 2 years before the examination; it should not have devalued its currency within the mechanism during this period.

Due to the extraordinary events of 1992, criteria v) has essentially been dropped by the EMI. (A kinder interpretation might be that it has been "re-interpreted"). Much has been written on these criteria, and in particular, the fiscal criteria iii) and iv) have been the focus of much attention (see Goodhart

(1991), Buiter, Corsetti and Roubini (1993), Langfeldt (1992), Papadia and Schioppa (1993) and Centre for Economic Policy Research (1991), among others).

The first two criteria are very well specified, and make economic sense in the context of the economic circumstances prevailing when the Maastricht Treaty was signed. If stable exchange rates are to be achieved, then inflation convergence in terms of tradable goods would be advantageous. In terms of criteria ii) (long-term interest rates), high intra-EC capital mobility combined with criteria v) (the ERM) would imply that long-term interest rate differentials would only occur with differential default risk. Eliminating such differential risk may be the motivation behind criteria iii) (government deficits) and iv) (government debt). As criteria i) (inflation rates) and ii) (long-term interest rates) are only entry conditions they appear to be sensible, not only because they are defined in relative terms, but also because they closely link the entry conditions so as to be dynamically consistent with the final objective. Criteria iii) and iv) (government deficits and debt, respectively), in contrast, are absolute objectives that, inter alia, bear little relation to the eventual objective. They are, however, linked with the section in the treaty dealing with the coordination of national policies (Articles 102a and 103). Table 3 summarises the Maastricht criteria.

TABLE 3

The Maastricht Convergence Criteria

Criteria	Nature	Entry Condition?
i) Inflation rate	Relative	Entry
ii) Interest rate	Relative	Entry
iii) Govt. deficit	Static	Continuing
iv) Govt. debt	Static	Continuing
v) ERM	Relative	Entry

It should be noted that the ERM conditions are really a 'relative' criteria because the Ecu itself is a basket of all EMS currencies, and further, although the ERM may continue after stage 3 of EMU begins, as soon as all Member States adopt the Ecu, the ERM will cease to exist. Also, and most importantly here, the fiscal criteria would not be relaxed but act as a measure for ensuring that Article 104c(1) ("Member States shall avoid excessive deficits") of the Maastricht Treaty is not transgressed.

b) Fiscal Policy and EMU

Are the two fiscal criteria sensible as entry conditions, in other words are they attainable objectives for Member States objectives by 19997 It is widely recognised that most EC Member States are far from achieving these objectives; Buiter, Corsetti and Roubini (1993) have estimated what constant % deficit-GDP ratio would have to be maintained to cut the debt-GDP ratio to 60% under various scenarios, and find that the results for Belgium, Italy and Ireland are unrealistically punitive and "describe the economics of the lunatic asylum". The implication being that these criteria are not realistic entry conditions for EMU.

In the context of a monetary union, are fiscal criteria desirable in terms of the credibility of the union and the stance of overall fiscal policy for a Member State? The need for such criteria or rules was set out originally in a paper by Lamfalussy (1989); the most pertinent of the reasons for such criteria are as follows:

- the desirability of an appropriate fiscal policy for the union as a whole;
- the need to avoid disproportionate use of Community savings by one country; and
- a possible bias towards lack of fiscal restraint.

The desirability of a pan-European fiscal policy, as far as Goodhart (1991) is concerned, is the least contentious reason for fiscal EMU criteria, but reference to other mature federations suggests that the second two reasons are unlikely consequences of abandoning fiscal criteria.

Lamfalussy recognises, in the second case, that this (disproportionate use of Community savings) could only occur "if a particular government encountered refinancing difficulties" which caused the EC to "bail out the government in financial trouble" (p.96). But the Treaty (Article 104b) makes it very clear that the Community or any other "Member State shall be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law or public undertakings of another Member State". The other circumstance that Lamfalussy gives for this need is if excessive borrowing by one Member State raised the interest rate level throughout the Community, causing crowding out in countries where the interest rate would have been lower. But, market risk premia should act to reflect the size of debt and ability to repay debts. Lamfalussy points to the fact that governments are not subject to the same market discipline as companies are when participating in the debt market, and in addition he stresses the situation where the financial markets might expect a higher level of government to bail out a lower level of government (- the example of New York is used here). But in political terms this argument makes no sense. In the EU, with the exception of perhaps some "olive belt" Member States, the mere idea of defaulting on sovereign debt would have economic and political consequences that are much too horrendous to imagine for most governments.

As for a bias towards a lack of fiscal restraint, the example that Lamfalussy uses here is the restraining of regional government expenditure, particularly in the case of Italy. But he readily acknowledges that "the available evidence from federal systems would not seem to suggest a bias towards lack of fiscal restraint" and cites Canada and the US, where evidence confirms that markets differentiate between the various regions as regards credit risk. He then states that "it remains unclear, however, what are the factors ultimately accounting for the apparent lack of a bias (towards lack of fiscal restraint) in the states examined. This raises doubts about the extent to which their experience can be of guidance for foreseeable conditions within a European EMU." (italics added to clarify). To deny that the power of the democratic political process in combination with the financial markets is sufficient to ensure fiscal rectitude on the part of Member State governments or ultimately a change in government, is to question the compatibility of a market-based economy with democracy. If this compatibility is questioned, there is still no philosophical reason to choose to reject something just because the situation in which it is to be applied might be different from the norm. From a logical perspective imposing such criteria before the fact would, therefore, also seem to be inappropriate.

In addition, the Maastricht Treaty is very specific that debt is not to be monetised (Article 104(1)). Many Member States that currently enjoy the ability to monetise debt would thus have this avenue removed, and would therefore be more restricted in their ability to be fiscally irresponsible. Issuing debt appears to be the only route available for Member States post-stage 3.

In summary, therefore, there is apparently no reasonable economic rationale for fiscal entry conditions or national fiscal policy criteria after EMU is achieved, as has been defined in the Maastricht Treaty. The following section discusses dynamic aspects of the fiscal criteria in the transition period to stage 3.

c) Dynamic "let-outs"

As the fiscal criteria pose almost insurmountable problems for several EU Member States (notably Italy, Belgium and Greece), 'let-out' clauses were added into the Maastricht Treaty to enable these Member States to participate in EMU even though they might not meet all the specified criteria. The Excessive Deficit Procedure laid out in the Treaty specifies that:

"The Commission shall monitor the development of the budgetary situation and of the stock of government debt in the Member States with a view to identifying gross errors. In particular it shall examine compliance with budgetary discipline on the basis of the following two criteria:

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." (Article 104c(2))

Firstly, note that it is the Commission that is enjoined to identify whether Member States have committed "gross errors". "Gross errors" clearly refer to whether the reference levels defined in the criteria have been transgressed, but a further arbitrary dynamic component has been overlaid onto these absolute measures to provide "let-cuts" for certain Member States.

Secondly, note that most emphasis is placed on the government deficit criteria, as if countries run primary surpluses, then total debt logically falls by definition. Of the high debt countries (as noted recently in Financial Times (1994c)), Belgium, Ireland, Italy and the Netherlands all had significant primary surpluses in 1993. Belgium, Italy and Greece all had debt ratios in excess of 100 per cent of GDP for 1993 and the Netherlands and Ireland all had debt ratios in excess of 80 per cent of GDP for the same year.

These dynamic "let-out" clauses are extremely flexible due to their generic nature and the fact that the Commission, hardly a disinterested party, will decide when and where "gross errors" occur. These subtleties have a further implication: it is clearly in a Member State's best interests to strive to meet as many of the entry conditions to EMU as possible in order to enter stage 3, but these dynamic "let-out" clauses make little sense once EMU is achieved. Given the loss of monetary and exchange rate policy levers on entering stage 3, Member States will have little incentive to abide by the fiscal discipline endemic in the dynamic "let-out" clauses in the longer term: the business cycle coupled with the insipid penalties that the Council could impose upon Member States (Article 104c(11)) would provide enough reason not to 'stay the course'.

So, in brief, there is no economic rationale for the fiscal policy criteria as entry or continuing criteria, but given the criteria remain in force, it makes little sense to continue with dynamic "let-out" clauses after stage 3 begins.

d) Credibility Issues

Excessive flexibility in applying the fiscal policy criteria, both pre- and post-entry into stage 3 of EMU, as well as the abandonment of the narrow margins of fluctuation for the ERM of the EMS may lead to a lack of credibility in the whole EMU process, particularly in light of the significant changes that have taken place in Europe since the signing of the Maastricht Treaty.

In terms of exchange rate fluctuations, the Maastricht Treaty states that the criterion should be that a "Member State has respected the normal fluctuation margins provided for by the ERM of the EMS without severe tensions for at least the last two years before the examination" by the European Council (Protocol on the Convergence Criteria, Article 3). Following the exchange rate turbulence in the latter half of 1992, Italy and the UK left the ERM and all members, with the exception of the Netherlands, widened their fluctuation bands to +/-15% from the previous "narrow" bands of +/-2.25%. So now, application of this criteria hinges upon the interpretation of what is "normal". A +/-15% fluctuation margin is not "normal" when put in context with the last 15 years of the operation of the ERM of the EMS, and is tantamount to operating a quasi-flexible exchange rate policy. So if the European Council decides to interpret "normal" as +/-15%, then this renders this exchange-rate convergence criteria as effectively redundant (see Financial Times (1994b,c)). The economic policy implication of such an interpretation is that exchange rate policy then becomes a policy lever that can be used by Member States in the transition period to stage 3 of EMU.

In order to enter into stage 3 of EMU, many Member States will be relying on an application of the looser dynamic "let-out" clauses rather than a strict interpretation of the fiscal convergence criteria.

The design of the EMU process in the form of its original blueprint, relied heavily on the credibility of the ERM of the EMS to achieve convergence and a reasonable degree of price stability (which in turn would narrow interest-rate differentials). Without this exchange rate policy anchor, the whole process of EMU becomes arbitrary. The potential for conflict and an over-riding reliance on the degree of emphasis placed on the Commission's decisions as to what is "excessive" becomes operative, which may potentially give Member State governments an incentive to adopt various expedient policies

during the transition period. The argument here is similar to that of dynamic inconsistency (see Barro and Gordon (1983)).

But notwithstanding the above argument, abandonment of the ERM of the EMS could potentially lead to other problems: why should inflation rates converge to within 1.5% of the lowest inflation rates in the EU?. Each Member State's inflation rate will be determined by indigenous monetary policy, not, as previously, by the exogeneity of an external exchange rate constraint. Similarly, interest rates need not converge, as the removal of the exchange rate constraint will lead to more divergent risk premiums.

In summary, the convergence criteria, as currently devised, do not, in the present circumstances, represent a consistent set of objectives (or 'means') for achieving the ultimate objective (or 'end') of EMU. If anything, the Maastricht convergence criteria represent obstacles to the attainment of EMU, and will almost certainly ensure that the peripheral Member States have to tread a path of 'greatest resistance' to get to the desired objective.

V. The Maastricht Treaty and Evaluation of Feasible Alternatives

The Maastricht Treaty is a reality, but EMU is not yet cast in stone. When a review of the progress towards achieving EMU occurs at the Inter-Governmental Conference (IGC) scheduled for 1996, the Maastricht Treaty may not be annulled without significant procedural problems, and with the exception of the UK, there is little will in the Union to take this route. (For an economic perspective in favour of scrapping EMU altogether, see De Grauwe (1994)).

a) A Critical Assessment of Maastricht

The virtual abandonment of the ERM of the EMS makes "the transition strategy to monetary union devised in the Maastricht Treaty impracticable" (De Grauwe (1994)). The objective of Maastricht was to replace the current arrangements in the EU with a monetary union and a weak federalist structure, but with restrictions on regional fiscal autonomy. This combination of objectives is inconsistent, given the experience of other federal structures and given existing economic theory.

Economic theory has little to say about transition to a monetary union, but it does have something to say about optimum currency areas. In optimum currency areas, the monetary union works best when there is a flexible labour force with a significant level of mobility so as to offset any asymmetric shocks. Further, in optimum currency areas, some form of fiscal redistributive process should be in place to enhance cohesion among the participants.

Economic theory aside, transition processes should not be dependent on criteria. The example of GEMSU reinforces this point. German monetary union was not dependent on economic criteria but was justified solely on political and social grounds. In Germany, once monetary union was achieved, then the process of economic convergence began, albeit with severe economic distress in some regions, and despite objections from 'economist' viewpoints at the Bundesbank. The economic dislocation in Germany, one might argue, was minimised by a well-educated and mobile labour force in the former East Germany (in addition to the fact that East Germans speak the same language as West Germans), and this would not be mirrored in Europe as a whole (consider the Portuguese, for example).

But arguments about labour mobility miss the point. To refute arguments that economic criteria are necessary to achieve a monetary union, one only has to consider objectives: was the ultimate objective to achieve monetary union or to foster convergence? If the ultimate objective is to achieve monetary union, then it is relatively easy to implement in one rapid ('Hawaiian') step. If the objective is to achieve economic convergence in the Union, then an adjustable-peg exchange rate regime with fiscal transfers is probably the easiest route (as envisaged in the original Delors Report). If the ultimate objective is both monetary union and economic convergence, then it is far easier to implement monetary union and then strive for economic convergence than vice-versa. As the objectives of EMU are by definition both economic and monetary union, then it seems sensible to adopt a 'monetarist' approach. The only issue then becomes how you get to monetary union (i.e. the rate of conversion for national currencies to the Ecu). Economic convergence prior to monetary union virtually disqualifies the poorer, more inflation-prone Member States of the Union from attaining EMU for some years to

come, and favours the richer, less inflation-prone Member States. In this sense, the Maastricht Treaty has put the cart before the horse.

If the Maastricht convergence criteria are collectively inconsistent and furthermore are unlikely to be of help in advancing EMU for all but a few Member States, it is unclear from an economic perspective as to why the architects of Maastricht chose this particular combination of timetabling and economic criteria. The combination was probably the result of political 'horse-trading' and ad-hocery. Indeed, Frankel (1993) suggests that the treaty may be a modern-day economic version of the mythological notion of the quest (for example, Jason of the Argonauts) with the fiscal criteria as the object of the quest and EMU the prize. Under this interpretation, the object could either be a test of will or a 'Machiavellian plot' on the part of the Bundesbank to torpedo the plans for EMU altogether!

Table 4 below shows which Member States currently satisfy the Maastricht criteria, as of April 1995.

TABLE 4

Which EU Members States Satisfy the Maastricht

Member State	i) Inflation rate	ii) Interest rates	iii) Budget deficit	iv) Public debt
Belgium	Yes	Yes	No	No
Denmark	Yes	Yes	No	No
Germany	Yes	Yes	No	Yes
Greece	No	No	No	No
Spain	No	No	No	No
France	Yes	Yes	No	Yes
Ireland	Yes	Yes	Yes	Yes
Italy	No	No	No	No
Luxembourg	Yes	Yes	Yes	Yes
Netherlands	Yes	Yes	No	No
Portugal	No	No	No	No
United Kingdom	Yes	Yes	No	Yes

Source: EMI (1995)

In the following sections feasible alternatives to Maastricht are presented: firstly in terms of amendments to the current treaty that might address the problems cited above while retaining the whole notion of gradualist approach to EMU, and secondly in terms of replacing sections of the Treaty with other viable alternatives.

b) Amending the Treaty

The original Delors Report (Committee on Economic and Monetary Union (1989)) proposed a strategy for EMU based on two axioms (as Fratianni, von Hagen and Waller (1992b) identify), 'parallelism' and
the use of the EMS as the launching pad for the process. The principle of parallelism states that EMU "form two integral parts (economic union and monetary union) of a single whole and would therefore have to be implemented in parallel" (para. 21, parentheses added). The justification for parallelism in the Delors Report is that "monetary union is only conceivable if a high degree of economic convergence is attained" (para. 21). But the report does not really distinguish the process of economic convergence with the attainment of the state of economic union, in terms of linking monetary union with the aims of a single market (supposedly attained at the beginning of 1993). Monetary union clearly enhances the benefits of a single market, but without sufficient fiscal latitude for Member States or fiscal sovereignty at the EU level, the process of economic union will take a much longer time to run its course. So the modifications to the Maastricht Treaty that, following the assessment above, would avert a "two-speed" EMU process and make the treaty workable in economic terms, are ones that enhance convergence, but do not impose a "no-entry" clause for those countries unlikely to meet the static fiscal criteria nor appeal to subjective 'dynamic' criteria. The proposed possible options for modification of the treaty are measured against Maastricht as is, and a slight hardening of the Maastricht conditions. They are as follows:

i) drop the dynamic fiscal criteria and retain all other fiscal criteria with no alterations to projected EU budgets and allow for a multi-speed EMU; or

ii) maintain all fiscal criteria with no alterations to projected EU budgets and allow for a multi-speed EMU; or

iii) drop the fiscal criteria altogether with no alterations to projected EU budgets; or

iv) drop the dynamic fiscal criteria, drop the debt ntry condition but maintain the budget deficit entry condition, drop the fiscal conditions post entry into stage 3, and slightly increase the EU budget; or

v) drop the dynamic fiscal criteria, drop the debt condition (both as entry and post entry), maintain the budget deficit criterion (as both an entry condition and as a post-entry into stage 3 condition), and moderately increase the EU budget; or

vi) drop the debt entry condition, maintain the budget deficit criterion (both as an entry condition and as a post-entry into stage 3 condition), maintain the debt condition post-entry into stage 3 and substantially increase the EU budget and increase fiscal competences; or

vii) drop all entry conditions, but maintain post-entry into stage 3 conditions, and substantially increase the EU budget and increase EU fiscal policy competences.

The 7 options are summarised below in table 5.

TABLE 5
Options for Modifying Maastricht

Option	Drop Dynamic	Drop Deficit Criteria Pre	Drop Deficit Criteria Post	Drop Debt Criteria Pre	Drop Debt Criteria Post	EU Budget	2-Speed EMU
i)	Yes	No	No	No	No	Same	Yes
ii)	No	No	No	No	No	Same	Yes
iii)	Yes	Yes	Yes	Yes	Yes	Same	No/Yes
iv)	Yes	No	Yes	Yes	Yes	+	(No)
v)	Yes	No	No	Yes	Yes	++	(No)
vi)	No	No	No	Yes	No	+++	No
vii)	No	Yes	No	Yes	No	+++	No

i

For all seven options, several other permanent alterations to the treaty are recognised. These are firstly, either the abandonment of the narrow bands of the ERM of the EMS as an entry criteria, which probably heralds a death-knell for the ERM, as in fact has happened (a view which was originally espoused by the 'MIT6', a group of academic economists from the MIT - see Financial Times (1993b)), or the imposition of appropriate measures to allow the ERM to operate under narrow bands again (such as capital controls or a tax on foreign exchange rate transactions - see Eichengreen and Wyplosz (1993) on this point). Secondly, there may have to be some change in the timetable for EMU - a 1999 inception for stage 3 would appear more appropriate in the light of recent events, but much depends on the progress of Germany and how the "dynamic" fiscal conditions are to be interpreted.

The first option (option i)) would accept all the Maastricht criteria, but would drop the dynamic 'let-out' clauses, and would therefore substantially elongate the period of time over which stage 3 is in force. It has been suggested that Germany is wedded to the notion of a "two-speed" EMU, because it wishes to maintain hegemony over European monetary policy. Indeed recent reports in the press suggest that the fear of losing autonomy over monetary policy has prompted the German Finance ministry to prepare for allowing the DM to circulate alongside the ECU in the first few years of EMU, as an insurance against an undesirable outcome in EMU. Alesina and Grilli (1993) use a simplified model that suggests that by proceeding at "two speeds", the achievement of complete integration would be in jeopardy. In other words, the path dependency of the

final outcome would determine the extent of monetary union within the EU. Option ii) is basically the current conditions, as specified in the Maastricht Treaty.

Option iii) completely eliminates the fiscal criteria (and therefore implicitly the Protocol on the Excessive Deficit Procedure). This option recognises that the fiscal criteria are arbitrary in nature and are perhaps desirable, but not necessary conditions, for attaining EMU. A "two-speed" EMU would for the most part be averted under this option. De Grauwe (1994) has recommended a variation of this option, invoking the principle of free choice by letting each Member State decide when and if they wish to join EMU. By invoking this principle, though, a "2-speed" EMU process becomes almost a certainty.

The next four options allow slight variations to the Maastricht Treaty conditions, but all allow EMIl to be realised, while allowing increased national fiscal autonomy and altering the current plans for only a slight expansion of the EC budget. Option iv) maintains the budget deficit criteria as an entry condition, thereby recognising the importance of an attempt by the more inflation-prone Member States to curb deficits. Note that maintaining a budget deficit of 3% or less would not necessarily lower debt/GDP levels. To counter this constraint on national fiscal autonomy on the approach to stage 3, the EU budget would undergo a slight increase over current projections to 1999.

Option v) alters option iv) by imposing the budget deficit criterion both as an entry condition and post-entry into stage 3. Under this scenario, the EU budget would need to continue increasing so that it reached levels envisaged by the McDougall Report (over twice the level for 1999 that was agreed upon at the Edinburgh summit).

option vi) adds the debt condition post-entry into stage 3 but allows the dynamic fiscal criteria to be applied, thereby enforcing a reduction in debt-GDP ratios in addition to constraining budget deficits. Here, not only would the EU budget have to substantially increase to allow moderate budget surpluses, but also the EU would acquire some fiscal sovereignty, in the form of additional policy competences. This increase in the EU budget now goes beyond the levels recommended in the McDougall Report.

Option vii) would be identical to option vi) but would deny the usefulness of fiscal criteria as entry conditions. In other words, option vi) represents a modified 'monetarist' approach to EMU as, unlike option iii) which also drops the fiscal criteria, it takes other federal structures as a model but recognises the need to address the budget deficit and debt problems in some Member States. Again, substantial inter-regional resource flow would be permitted through a larger EU budget with more fiscal policy competences transferred to the EU level.

Economic options are all well and good, but what is politically feasible? In option i), the fiscal criteria are so unrealistic for certain Member States that their entry into stage 3 would be left to the discretion of the "first speed" countries and may not materialise. In option ii), the same fate may befall these Member States, but clearly much depends on the attitude of the Bundesbank to strict adherence to the Maastricht criteria and to the leeway for liberal interpretations of the dynamic "let-out" clauses by the EU. Indeed, with regard to the other options, the Bundesbank appears to have considerable clout in these negotiations, so some post-stage 3 entry conditions may still be necessary; at the other end of the spectrum, the UK government would be violently opposed to any 'federalist' structure with substantial redistributive powers for Brussels. This rules out options iii), vi) and vii), leaving only options i), ii), iv) and v). Option i) is unlikely to materialise, as southern European Member States are not going to give up the dynamic criteria for nothing in return.

From a bargaining perspective, options iv) or v) seem to be the most likely reasonable alternatives to option ii) (the status quo).
Clearly, much depends on the price that Germany is willing to pay to eliminate the dynamic "let-out" clauses, as to which of these would be favoured. Perhaps an additional "let-out" clause for Germany to continue using the DM during stage 3 could also be introduced into the bargaining as an appeasement. Both these options, and option v), in particular, would also be entertained by the European Commission, which has, for some time, been trying to justify more fiscal policy competences and give the European parliament more credibility as well as a greater role as a pan-European decision-making body (see Financial Times (1994a) for more on this).

c) Replacinq the Treaty

If one accepts that a parallel/gradualist approach to EMU is fraught with political and economic adjustment problems, other options are available. The options that considered are as follows:

i) an abandonment of gradualism and an attempt to pursue political and economic integration before the optional replacement of national currencies with the ECU; or

ii) a competing currency 'Hard ECU' option - issuance of ECUs by the ECB which would circulate alongside national currencies but at a fixed rate with the strongest currency in the EC; or

iii) a reinstatement of the ERM of the EMS as the vital stepping-stone to a single currency with appropriate measures to minimise speculative attacks.

These options are generic in nature, and could be combined: for example, option i) is not incompatible with option iii). Option i) is an 'economists' view of the integration process, with political and economic integration foreshadowing any monetary union - in this scenario monetary integration would come about in an evolutionary manner, once other policy instruments are in place and EC political institutions have had time to evolve. Option ii) would not necessarily call for a priori political and economic integration, but would operate in an evolutionary way, in this instance based on individual agent's monetary preferences. EMU then may never be completed as a process, but trade and cross-border transactions would be facilitated and fiscal restraint would be encouraged. Option iii) is perhaps the most controversial, and would necessitate a thorough review of the recent adverse experience of EC Member States with the ERM, as well as substantial reform of the political and defensive mechanisms that are embodied in such a system. John Williamson (.Financial Times (1993c)) echoed this view, recently advocating restoration of the EMS but with "rates...pegged at levels that make sense in the light of the fundamentals and that are promptly changed to reflect changes in the fundamentals". If a monetary authority such as the EMI were given complete control of the workings of the EMS, perhaps more prompt and appropriate adjustment would take place, confounding any speculative attacks on the system. Once economic convergence had been achieved, as defined by exchange rate stability and perhaps other criteria defined by an independent EMI, Member States could then proceed to replacement of national currencies with ECUs. Indeed, in the shorter term, whatever route is chosen, the European Commission is likely to push for attainment of EMU as rapidly as possible, as floating exchange rates threaten many of the policies of the Union, notably the common agricultural policy. Table 6 summarises these options:-

TABLE 6
Feasible Replacements for Maastricht

Option	Exchange Rate Stability?	Economic Union Complete?	"2-Speed" EMIl?
Maastricht	(Yes)	Converging	Yes
i)	(Possibly)	Yes	No
ii)	?	?	(Likely)
iii)	Yes	?	(Possibly)

As to the issue of which of these plans is politically feasible, only option i) precludes the possibility to a "two-speed" Europe. Indeed, in option ii), as long as legal tender provisions are in place in all Member States, the decision as to when to introduce EMU is removed from the national governments, and also from Brussels. Option iii) would probably be opposed by the UK, but as participation in the ERM is voluntary, it could hardly claim that its hands were tied. If adopted and effectively implemented, the UK would soon find itself left on the periphery of the integration process.

All of these options have, at some point, been advocated by economists. Nevertheless, replacing whole sections of the Maastricht Treaty is likely to be attempted only after failure to reach a consensus on modifications to the treaty - so in this sense all the above options are second-best political solutions compared with those advocated in section VIb). The interactions of the special interests of all the political parties concerned is the subject of the next section.

d) EMU = Economic Jinfism or a Pyrrhic Victory

In 1996, Member States will have a chance to amend the Maastricht Treaty at the scheduled Inter-Governmental Conference (IGC). Posturing on the issue of EMU has already started, as of writing, and will no doubt continue up until the IGC.

Among Member States, the critical factor affecting the outcome of this IGC will be the inclusion or otherwise of Germany in EMU. German concerns relate to:

i) the replacement of the DM with the Ecu;
ii) application of the fiscal criteria; and
iii) political union.

The first concern relates to replacement of a currency which the Bundesbank has monopoly control over, with a currency which will be controlled by the ECB Council. The members of this council will, in the transition period, consist of those countries which the European Commission deems to have met the criteria. As the dynamic 'let-out' clauses give the Commission great flexibility in exercising the fiscal criteria, several Member States that have historically had much higher inflation rates could become voting members of the ECB Council, thereby having a potentially large influence over pan-European monetary policy, and by implication, German monetary policy.

Replacement of the DM is the major motivation behind the recent expression of angst over the second German concern, that of credibility of application of the fiscal criteria. Ireland, the European Commission has argued, has a public debt that is "sufficiently diminishing" at a "satisfactory pace", so can proceed with EMU in 1996 (with Luxembourg). Belgium, Greece and Italy are now hopeful of the same leniency regarding the fiscal criteria, even though their public debt levels are over twice those stipulated by the fiscal criteria. This no doubt will be severely resisted by the Germans, but if they are unsuccessful this might prompt an activation of plans to allow the DM to circulate alongside the Ecu to become official German policy.

The third concern is the institutional aspects of EMU, and in particular the state of European Political Union (EPU). The Germans argue that the ECB, however independent, cannot operate effectively in a vacuum - a central bank has to have a governmental framework within which to operate. Besides the issue of democratic accountability, there is no equivalent of a finance ministry or treasury in Europe, so this will not allow the proper interaction between monetary and fiscal policy at the European level.

There are, of course, other concerns about how the Treaty might be amended and interpreted. The British have an opt-out clause for the whole process, but would be reluctant to exercise it if they were the only Member State not to participate in EMU. The southern European Member States are particularly concerned about the prospect of a "two-speed" EMU, if the fiscal criteria were to be strictly adhered to.

Indeed, the prospect of a "two-speed" EMU appears increasingly likely, with the 'borderless' Schengen Treaty countries (France, Germany, Belgium, Luxembourg and the Netherlands) with Ireland, forming the initial Ecu block. In political terms, this would create great divisions in Europe and might cause a severe rupture in cooperative efforts between Member States. Further, such a marked division might derail economic union and reverse the trend in economic convergence among EU Member States as a whole.

It is ironic, however, that if a compromise at the 1996 IGC exists, it is probably to be found in the ERM. Noteworthy, is the fact that despite the currency turbulence of 1991/92, most Member States have kept their currencies close to, or within the old ERM +/-2.25% fluctuation bands. So, if there is an aversion to a "two-speed" EMU, perhaps the ERM may have some role to play in a political compromise. One might envisage the ERM criteria coming back into play as a criteria, but at the same time another of the criteria being overlooked. So, for instance, one of the fiscal criteria could be replaced by the ERM criteria on a selective Member State basis. In this schema, Member States would be eligible to proceed to EMU if they fulfilled four out of the five of the Maastricht criteria. This

would be particularly attractive to the benelux countries (with the exception of Luxembourg, which already satisfies all the four remaining criteria), as both Belgium and the Netherlands would expect to be part of the "hard core" Member States entering EMU initially, yet they both fail to meet both of the fiscal criteria. In such a schema, this would also avoid any indiscriminate use of the dynamic "let-out" clauses.

VI. Conclusions

It is unfortunate that the objective of EMU forced upon the EMS
a role for which it was not designed. If EMU is to be realised in the current political climate, the EMS will probably remain on the periphery of the integration process, a relic of earlier ambitions to stabilise European exchange rates. Nevertheless, in the light of the severe economic conditions imposed by the Maastricht Treaty on some Member States, perhaps the EMS's demise is unfortunate, given that it could (in its narrow band version) be part of a revised Maastricht blueprint in which Member States have to achieve four out of the five original criteria.

The natural adjoint to the economic issues surrounding the major obstacles to EMU, notably the fiscal criteria, is not primarily one of exchange rate instability, but rather that of the role of supranational institutions, particularly in relation to overall EU fiscal policy. Indeed, if attainment of EMU is foremost in policy-makers minds (and in some cases this is not at all certain), then reaching an acceptable compromise on modification of the fiscal criteria is paramount. The current Maastricht path and the criteria embodied in this approach will not allow the ultimate objective of EMU to be attained.

The most likely outcome, if a "two-speed" EMU is to be avertedis a political trade-off between abandonment of the dynamic "let-out" clauses to the fiscal criteria and abandonment of the debt criteria, while modestly increasing the evolution of the EU budget. The range of possible outcomes poses important questions about the role of political union in the EU, the implementation of the principle of subsidiarity and the division of economic policy competences between the EU and Member State governments.

EMU is certainly not dead, but the process of keeping it alive has already compromised the objective of European exchange rate stability (the EMS) and will inevitably pose further economic problems and difficult policy choices. It is easy to find examples of common currency areas that do not fulfill the economic conditions of an optimum currency area - perhaps these examples can shed some light through further research on the obstacles still to be overcome in Europe.

Lastly, from a history of thought perspective, it is interesting to note that the European economic debates of the early 1970s are still alive and well, not in their original 'economist' versus 'monetarist' guise, but as a "two-speed" versus collective approach to EMU (or northern versus southern European Member States). The fact that this debate is still alive is not because the wheel has been re-invented, but rather because of the fact that the issue of the optimal approach to economic integration has not yet been resolved.

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