Opinion of the Central Bank Council concerning convergence in the European Union in view of Stage Three of economic and monetary union

Under section 13 (1) of the Bundesbank Act, the Deutsche Bundesbank is required to advise the Federal Cabinet on monetary policy issues of major importance, and to furnish it with information on request. By submitting the present Opinion, the Bundesbank is complying with the Federal Chancellor's request for a written expert opinion on convergence in the European Union in view of Stage Three of economic and monetary union, and is thus fulfilling its statutory reporting obligation. In this Opinion, it assumes that the Federal Cabinet has to take its decisions in the EU Council in accordance with Article 109j of the EC Treaty on the basis of an assessment of convergence in the individual member states. The starting point of its Opinion is the detailed Reports presented on March 25, 1998 by the European Monetary Institute (EMI) and the Commission of the European Communities, and the figures included therein. The Bundesbank's Opinion is based in large part on the analyses contained in the EMI Report.

I. The prerequisites and implications of the monetary union as a community of stability

1. The start of Stage Three of European economic and monetary union is an event with momentous economic and political consequences. The introduction of a single cur-

rency eliminates exchange risk between the participating states, enhances planning security (especially for corporations) and lowers transaction costs. The expected increase in competition is likely to improve the deployment of the factors of production and heighten the efficiency of the financial markets, with the result that, over the longer term, the scope for growth, the potential for innovation and the employment opportunities in European economies can be exploited to a greater extent. Outside the purely economic sphere, monetary union may be a major step on the way to a more far-reaching political union in Europe.

2. In its statements prior to the start, and after the conclusion, of the Treaty negotiations, the Central Bank Council highlighted at an early date a number of considerations which it regards as important, and to which it would like to draw attention once again.

In the statement dated September 6, 1990, it said in the introduction:

"... the participating economies will be inextricably linked to one another in the monetary field, come what may. The implications of this – especially for the value of money – will depend crucially on economic and fiscal policy, and on the stance of management and labour in all member states. They will have to satisfy in full the requirements of an economic and monetary union."

In addition to this statement of principle on the significance of a monetary union and the implications thereof, that statement stressed not only the institutional prerequisites of a single monetary policy but also the paramount importance of counter-inflationary convergence before the start of the Final Stage of monetary union:

"... The convergence of anti-inflation policies between all the member states participating in the monetary union must have progressed so far that

- inflation has been very largely stamped out in all the countries, and price differentials have been virtually eliminated,
- budget deficits in all the participating countries have been reduced to a level which is sustainable in the long run and poses no problems for anti-inflation policy, and
- the durability of the convergence achieved is likewise reflected in the markets' assessment – i.e. in a significant harmonisation of capital market rates.

All the member states taking part in the monetary union must previously have participated for a sufficiently long period, without any special arrangements, in the exchange rate mechanism of the EMS, and must have irrevocably dismantled all restrictions on capital movements."

After the conclusion of the Treaty negotiations, the Central Bank Council, in its statement dated January 23, 1992, rated the institutional design of the Final Stage envisaged in the Treaty as being largely in line with the Bundesbank's recommendations. At the same time, however, it pointed out that the question of whether an economic and monetary

union is to be established has to be decided by the politicians.

Regarding the importance of sufficient and sustained counter-inflationary convergence for the success of the agreed monetary union, that statement said:

"The decision-making procedure envisaged for the entry into the Final Stage is intended to ensure that only those member states which have demonstrated their willingness and ability to pursue a sustained anti-inflation policy can participate fully in EMU. ... the success of anti-inflation policy in the monetary union will hinge upon the range of participants being strictly oriented towards the entry criteria, and upon admission being granted only to countries with persistently low rates of inflation ..."

"It will be of prime significance for the overall success of the envisaged economic and monetary union that the Community decisions to be taken in 1996 and 1998 on the selection of the countries eligible for participation in EMU be geared solely to those countries' counter-inflationary performance."

Thus, from the outset the Bundesbank drew attention to the fact that strict standards will have to be applied to the assessment of convergence, in order to ensure the viability of monetary union.

3. In the resolutions of the Deutscher Bundestag and Bundesrat dated December 2 and 18, 1992, on the occasion of the ratification of the Maastricht Treaty, it said, inter alia:

"... on the transition to Stage Three of economic and monetary union, the stability criteria [will have] to be interpreted narrowly and strictly. The decision on the transition to Stage Three can only be taken on the basis of proven stability, of convergence of the underlying economic data and of proven, sustainable budgetary and fiscal soundness on the part of the participating member states. It must not be based on opportunist considerations. The nature of the criteria entails that their fulfilment cannot be ascertained only statistically. Instead, their long-term fulfilment must also appear credible in the light of the course of the convergence process."

The Federal Constitutional Court explicitly referred to these resolutions in its ruling of October 12, 1993.

4. On several occasions, the European Council has called for strict compliance with the convergence criteria and the sustainability of the consolidation measures. In the Presidency Conclusions of the Dublin European Council dated December 13 and 14, 1996, it said in this context:

"The Council takes this opportunity to stress that the four criteria of sustainable convergence and the requirement of central bank independence must be strictly applied. This is essential if the coming completion of monetary union is to have the essential quality of stability and the euro is to be assured of its status as a strong currency. It is equally important that ... government financial positions in particular are sustainable and not affected by measures of temporary effect."

These statements underline the paramount importance of adequate and persistently stability-oriented convergence for the lasting success of monetary union. The Central Bank Council is guided by these yardsticks.

II. The Treaty's stipulations and their interpretation

1. Pursuant to Article 109j (1) of the EC Treaty, the examination of the prerequisites for qualifying for the Final Stage of monetary union must cover not only the adjustment of a country's national central bank legislation but also, in particular, the demonstration that it has achieved a high degree of sustainable convergence. The yardstick by which this is to be judged is whether the individual member states meet the following criteria:

(a) the achievement of a high degree of price stability, apparent from a rate of inflation which is close to that of, at most, the three best-performing member states in terms of price stability;

(b) the sustainability of the government financial position, apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 104c (6) of the EC Treaty. According to the Protocol on the excessive deficit procedure and Article 104c (2), the reference values are

- 3 % for the ratio of the planned or actual government deficit to gross domestic product at market prices, 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;
- 60 % for the ratio of government debt to gross domestic product at market prices, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

In deciding whether an excessive deficit exists pursuant to Article 104c (6), the Council must also assess the overall situation.

(c) The observance of the normal fluctuation margins provided for by the exchange rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other member state,

(d) the durability of the convergence achieved by the member state and of its participation in the exchange rate mechanism of the European Monetary System, as reflected in the long-term interest rate levels.

These criteria are of paramount importance for two reasons:

- As part of the Treaty they were the subject of the ratification procedure. Hence for many people the credibility and accept-

ability of monetary union are linked to the observance of these criteria.

– In economic terms the criteria are the proof that the member states really are prepared for coping with the specific circumstances of monetary union and therefore would not be a burden to a lasting community of stability.

Each of these four criteria is significant in its own right and they must be assessed – separately and in their associated context – in the light of the stipulated objective of lasting convergence in terms of stability policy.

A key point to be considered in assessing the candidates is the degree of durability of the convergence achieved. If the requirements are met only at the time of entering the Final Stage of monetary union, or if perhaps even adjustment measures are taken which will have reverse effects in future periods, that does not suffice. That is why it is important not only to study the present position but also to analyse developments in the past and, on that basis as well as on the basis of the decisions taken so far, to show realisable perspectives for the future. Convergence is not synonymous with merely managing to meet particular criteria at a given point in time but has to be interpreted rather as a process which is of continuing significance precisely during the period following the launch of monetary union. The fact that a Stability and Growth Pact was concluded on the basis of the Treaty is in keeping with this interpretation. That Pact streamlines the budgetary surveillance procedure in the member states and stipulates as the target objective having, in normal cyclical situations, a budgetary position that is close to balance or in surplus. The Pact would forfeit credibility and effectiveness if the medium-term budget plans of the individual member states were to fail to meet its demands already in the initial years of monetary union.

2. The Maastricht Treaty, together with the Statute of the European System of Central Banks (ESCB) and of the European Central Bank (ECB), laid the legal basis for ensuring that the ESCB can pursue a stability-oriented monetary policy.

For assessing whether a member state qualifies for monetary union, the EC Treaty not only requires that it meets the economic criteria but also stipulates the achievement of legal convergence. Pursuant to Article 109j (1) of the EC Treaty, the Commission and the EMI must examine the extent to which the national legislation of the countries involved, especially the member states' central bank statutes, are compatible with the Treaty and the Statute of the ESCB. The primary requirement is the legal enshrinement of the independence of the national central banks in the performance of their ESCB-related tasks. Article 107 of the EC Treaty stipulates that not only the ECB but also the national central banks must be independent. Article 88 sentence 2 of the German Constitution likewise permits the transfer of monetary policy tasks solely to an independent European Central Bank that is committed to safeguarding price stability as its primary goal.

The EC Treaty does not merely rely on the primacy of Community law over national law. It imposes on the member states an explicit obligation to adapt their legislation by the time of the ESCB's establishment and at the same time underlines the crucial importance of the new system's independence as an institutional prerequisite for a monetary policy geared to price-level stability.

In its Convergence Report, the EMI detailed the yardsticks for assessing the achievement of legal convergence, especially in the two fields

- independence of the national central banks, and
- integration of the national central banks into the ESCB.

The Report spells out the different points in time by which the process of adaptation in the fields mentioned must take effect. Whereas the task of integrating the national central banks into the new system is to be tackled upon entering Stage Three, their independence must be explicitly enshrined in law at the latest at the time the ESCB is established. During the period between the establishment of the ESCB and the launch of Stage Three, the ECB Governing Council will take decisions which will predetermine the future single monetary policy and its implementation. When taking these fundamental decisions, the governors of the national central banks represented in the ECB Governing Council must be independent of instructions from national authorities. This applies also to the other members of decision-making bodies of the national central banks that are entrusted with ESCB-related tasks and which, during this preparatory phase, have to take important seminal decisions regarding the implementation of the single monetary policy.

The central legal framework for the ESCB in the form of its primary commitment to price stability and the independence both of the ECB and of the national central banks is complemented by the prohibition of lending by central banks to the public sector, the prohibition of granting the public sector preferential access to financial institutions and by the exclusion of liability on the part of the Community for liabilities of individual member states.

III. The importance of the macroeconomic environment

1. In economic terms, monetary union implies the adoption of a single monetary policy which is committed to price stability. The irrevocable fixing of the exchange rates within monetary union means that the participants will forgo a mechanism of economic adjustment on an enduring basis. Above and beyond that, monetary union will go hand-in-hand with restraints insofar as the present and, in some cases, diverging economic and political traditions of the member states will have to be incorporated into the new supranational framework on a lasting basis, with national interests being set aside. The single market itself – in which, however, major structural elements, especially in capital income taxation and indirect taxation, are not yet adequately in place – requires an appre-

ciable willingness to adjust on the part of enterprises and economic policy.

In a supranational monetary union, divergences may repeatedly occur which have to be met by national economic, financial and social policy measures – not, however, by monetary policy, which will apply throughout the European Union. Thus, varying levels of unemployment in the individual member states might place a considerable burden on monetary union. On the other hand, there exists the opportunity that monetary union will improve the conditions for higher employment in the long term. Ultimately, monetary union will be all the more successful, the more flexible the goods, financial and labour markets are. And this calls for an economic policy everywhere which is compatible with the objective of price stability.

2. Fiscal policy has a particular responsibility in monetary union. This concerns both the various levels of government and the funding of social security systems. A sustainable government financial position in the member states is indispensable if conflict between the member states and the single, stability-oriented monetary policy is to be avoided. Problems would arise if fiscal policy were to lead to a burden being imposed on the capital markets, to reactions on the part of the financial markets and to interest rate increases. This might lead to member states increasingly resorting to short-term financing, the upshot of which would be that fiscal policy would be directly affected by the interest rate decisions of the ECB. Conflicts with a stability-oriented monetary policy are all the more likely to arise, the higher the level of debt, the more short-term the structure of debt and the greater the share of external debt are. A concomitant of this would be the risk of political pressure on the European Central Bank and its decision-making bodies.

Moreover, excessive credit-financed government expenditure places too great a burden on the resources of the economy as a whole; that, too, may make a monetary policy geared to stability more difficult. Independently of this, consideration must be given to the impending heavy strains on the public sector budgets which will be imposed by growing pensions commitments and the deterioration in the ratio of contribution-payers and recipients of payments in the

Overview of the convergence of the EU states

Country	Inflation rate	Long-term interest rate	Public financial balance 1	Public Debt
	in %		as a percentage of GDP	
	Reference period:			
	February 1997 to January 1998		1997	
EMU reference value	2.7	7.8	– 3.0	60.0
Austria	1.1	5.6	– 2.5	66.1
Belgium	1.4	5.7	– 2.1	122.2
Denmark	1.9	6.2	0.7	65.1
Finland	1.3	5.9	– 0.9	55.8
France	1.2	5.5	– 3.0	58.0
Germany	1.4	5.6	– 2.7	61.3
Greece	5.2	9.8	– 4.0	108.7
Ireland	1.2	6.2	0.9	66.3
Italy	1.8	6.7	– 2.7	121.6
Luxembourg	1.4	5.6	1.7	6.7
Netherlands	1.8	5.5	– 1.4	72.1
Portugal	1.8	6.2	– 2.5	62.0
Spain	1.8	6.3	– 2.6	68.8
Sweden	1.9	6.5	– 0.8	76.6
United Kingdom	1.8	7.0	– 1.9	53.4

Source: European Monetary Institute, Convergence Report 1998. — 1 defizit (–).

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Consumer prices in the EU states

Change from the previous year in %

Country	On the basis of ...					
	... the national index				... the harmonised index	
	1992	1993	1994	1995	1996	1997
Austria	4.1	3.6	3.0	2.2	1.8	1.2
Belgium	2.4	2.8	2.4	1.5	1.8	1.5
Denmark	2.1	1.2	2.0	2.1	2.1	1.9
Finland	2.9	2.2	1.1	1.0	1.1	1.2
France	2.4	2.1	1.7	1.8	2.1	1.3
Germany	5.1	4.5	2.7	1.8	1.2	1.5
Greece	15.9	14.4	10.9	8.9	7.9	5.4
Ireland	3.0	1.5	2.4	2.5	2.2	1.2
Italy	5.4	4.2	3.9	5.4	4.0	1.9
Luxembourg	3.2	3.6	2.2	1.9	1.2	1.4
Netherlands	3.2	2.6	2.8	1.9	1.4	1.9
Portugal	8.9	6.5	5.2	4.1	2.9	1.9
Spain	5.9	4.6	4.7	4.7	3.6	1.9
Sweden	2.6	4.7	2.4	2.8	0.8	1.8
United Kingdom	4.7	3.0	2.3	2.9	2.5	1.8

Source: European Monetary Institute, Convergence Report 1998; EUROSTAT; national authorities.

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social security systems. They highlight the need for strict fiscal policy discipline.

In monetary union, it is primarily the task of national fiscal policy to take account of divergent trends in the member states. In order for the scope provided for in the Stability and Growth Pact to be sufficient, appropriate starting conditions must exist in the normal cyclical situation: in that connection, the Pact explicitly states the objective of a budgetary position that is close to balance or in surplus. This is not least the case so that fiscal policy will retain sufficient scope to react in the event of abrupt market changes which have a varying impact within the euro area. Since fiscal policy – in contrast to communitised monetary policy – will remain the responsibility of the member states, what will be especially crucial in terms of the government financial position is to demonstrate that it is sustainable.

The requirement of a sustainable government financial position (Article 109j (1) of the Maastricht Treaty) is linked particularly with the level of government debt. The higher public debt is, the greater the necessity of consolidation to maintain or regain the necessary room for manoeuvre in fiscal policy and to safeguard the markets' confidence in the soundness of public finance. There is a close correlation between the deficit ratio, the debt-to-GDP ratio and the nominal growth rate, which the Maastricht Treaty takes account of by explicitly referring to the reference values for both ratios. There has been much disagreement on the question of which of the two criteria is the more important. The debt-to-GDP ratio is a much better indicator of the risk of conflicts of interest between monetary and fiscal policy than the deficit ratio. In the long term, however, the budget balance also determines the debt ratio.

However, it is not primarily the convergence of fiscal policy at the start of monetary union which – however important it is – has to avert all these problems. Establishing enduring fiscal policy discipline on the part of the member states is a very complex and extremely difficult task. The regulatory policy basis of monetary union also means that no member state is able to risk incurring excessive debt by relying on the possibility of extricating itself, if the need arises, with a national inflationary policy. Moreover, the Treaty takes account of this problem by explicitly prohibiting assist-

Convergence of long-term interest rates *

in %

Country	1991	1992	1993	1994	1995	1996	1997
Austria	8.6	8.2	6.7	7.0	7.1	6.3	5.7
Belgium	9.3	8.6	7.2	7.8	7.5	6.5	5.8
Denmark	9.3	9.0	7.3	7.8	8.3	7.2	6.3
Finland	11.7	12.0	8.8	9.0	8.8	7.1	6.0
France	9.0	8.6	6.8	7.2	7.5	6.3	5.6
Germany	8.5	7.9	6.5	6.9	6.9	6.2	5.6
Greece	–	–	23.3	20.8	17.4	14.4	9.9
Ireland	9.2	9.1	7.7	7.9	8.3	7.3	6.3
Italy	13.3	13.3	11.2	10.5	12.2	9.4	6.9
Luxembourg	8.2	7.9	6.9	7.2	7.2	6.3	5.6
Netherlands	8.7	8.1	6.4	6.9	6.9	6.2	5.6
Portugal	14.5	13.8	11.2	10.5	11.5	8.6	6.4
Spain	12.4	11.8	10.2	10.0	11.3	8.7	6.4
Sweden	10.7	10.0	8.5	9.7	10.2	8.0	6.6
United Kingdom	10.1	9.1	7.5	8.2	8.3	7.9	7.1

Source: Calculations by the Bundesbank (underlying data: European Monetary Institute). — * Annual averages in % p. a.; calculated on the basis of harmonised long-term interest rates; where harmonised interest rates were not available, comparable data were used instead.

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ance for reducing debt ("no bail-out"). Even this, however, is not a guarantee that this will be avoided. It is for that reason, too, that the Stability and Growth Pact is important.

IV. The state of convergence in the European Union

1. As the EMI Convergence Report says, in many member states the necessary adaptations to bring about the independence of their central bank and to integrate it into the ESCB have been concluded. In most of the other member states the necessary legal adaptation will be ensured if the draft laws which had been elaborated by the time this Report was written are enacted in good time. That applies to Spain, France, Luxembourg, the Netherlands and Austria.

In some member states there are still some imperfections but these will not jeopardise the overall functioning of the ESCB at the start of Stage Three. To ensure the smooth functioning of the ESCB on a permanent basis, however, further legislative measures are necessary in these cases. That applies to the central bank statutes in Ireland, the Netherlands and Greece and – as a particularly urgent case – to the law governing the future central bank of Luxembourg. On the other hand, the draft amendment of the Swedish central bank statute displays incompatibilities with Community law which relate to the central bank's independence and its integration into the ESCB.

2. The relative economic convergence of each country is assessed according to uniform yardsticks on the basis of the Treaty and political stipulations. The starting point for the analysis presented here is the EMI Convergence Report. The Bundesbank also bases its estimations on the data of the EU Commission that were examined and compiled by the Community's Statistical Office (EUROSTAT). The data in question are primarily the harmonised index of consumer prices, the government deficit ratio and government debt ratio, the exchange rate trend and the harmonised yield on long-term government bonds.

Additional information has been drawn on, in particular, for assessing the durability of convergence of the government financial position. On the basis of its mandate, EUROSTAT was able to establish only that the collected historical data were in accordance with the defined rules of the European System of Accounts. This entailed no assessment of the underlying economic relationships. That requires a deeper analysis, for example, of measures with a temporary effect (one-off effects) which relate solely to the year 1997 and which may later even be self-reversing, of the maturity structure of government debt, of the fiscal policy plans for the coming years and of the future burdens which are already becoming evident, especially those due to demographic trends.

A further point that needs to be considered is that the expectation of a country's participation in monetary union has had a feedback effect on its fulfilment of the convergence criteria. The steep decline in interest rates in some member states, partly thanks to their own efforts and partly in anticipation of their expected participation in monetary union, has made it easier for them, and in some cases has even made it possible for them, to meet both the interest rate criterion and the deficit criterion.

In the introductory section of its Convergence Report, the EMI adopted a *modus operandi* for applying the convergence criteria with which the Bundesbank expressly agrees and which it follows in this Opinion.

3. As the EMI Report shows, far-reaching convergence has been achieved in the EU concerning the price criterion at a gratifyingly low level (see the tables on pages 23 and 24). With the exception of Greece, all the member states are below the reference value of 2.7 % for the average year-on-year increase in the harmonised index of consumer prices. For the near future, too, no particular dangers of inflation are seen in these member states that could call into question their continuing fulfilment of this criterion. The qualification must be made, however, that in some member states price stability is a relatively recent experience. It follows that a culture of stability cannot be regarded as being assured in all countries, although advances towards this goal have undoubtedly been made.

A cause for concern in this context are the very high and persistent unemployment rates throughout the Union. Thus, especially in the major economies, with the exception of the United Kingdom, more than one-tenth of the

* Calculated on the basis of harmonised long-term interest rates; where harmonised interest rates were not available, comparable data were used instead. The reference value is ascertained as an unweighted arithmetical mean of the long-term interest rates of the three countries with the most stable prices plus 2 percentage points. Source: calculations by the Bundesbank (underlying data: European Monetary Institute).

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labour force are registered as unemployed – not counting the various forms of covert unemployment. The rigidities which this situation reflects are a long-term burden on future stability policy. It would undoubtedly have been more reassuring if the statistically measured degree of price stability had been achieved in tandem with a high level of employment.

Another concern is that price pressures might grow in some countries that are further along the business cycle. Wage bargainers, in particular, but also the public authorities have a duty in this context to ensure that regional inflationary tendencies do not even begin to burgeon, so as not to burden the start of monetary union. In recent years there has been a sharp increase in overall labour costs, particularly in Greece and Italy, but also to some extent in Portugal and the United Kingdom.

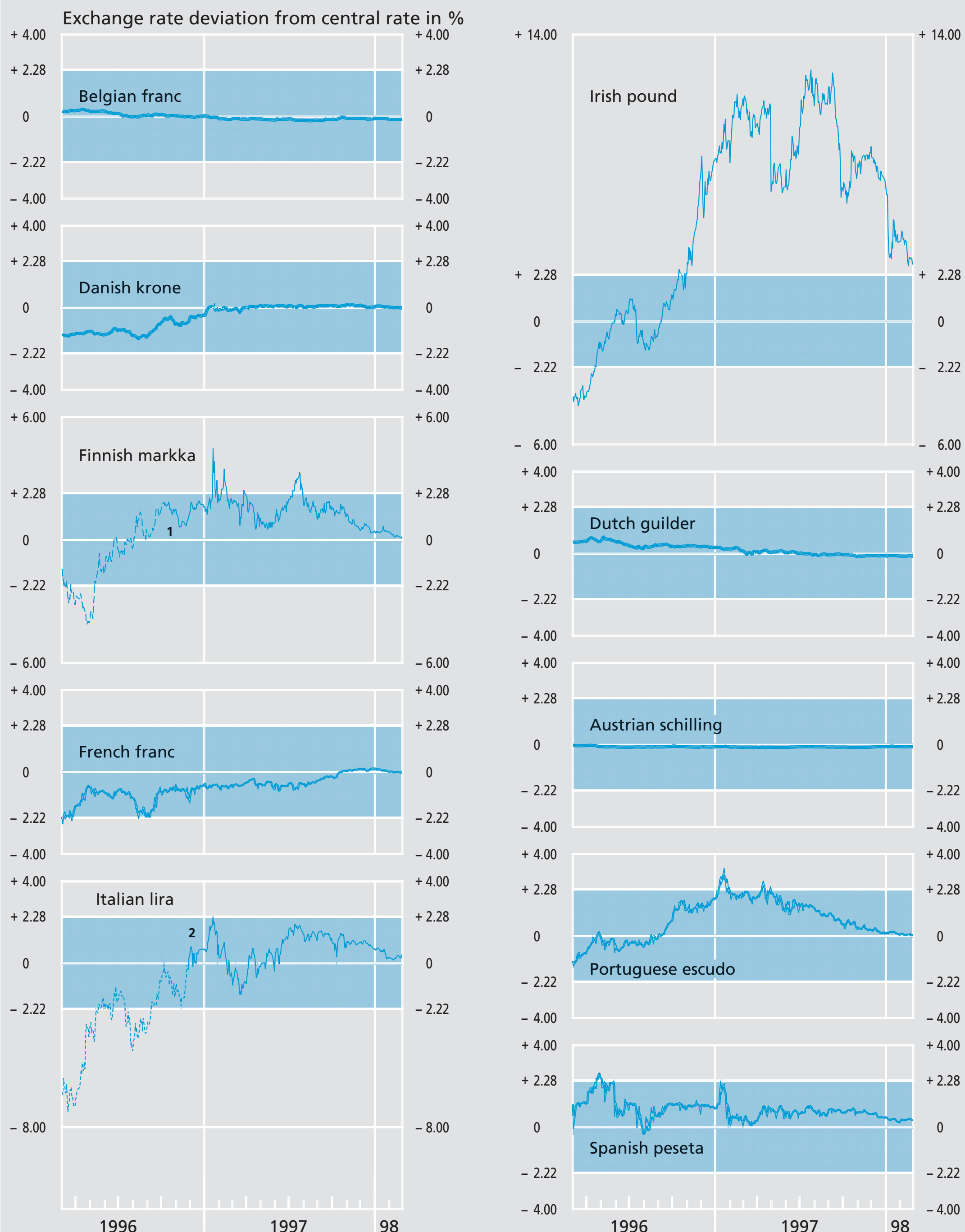
4. In respect of long-term interest rates, too, all EU countries – with the exception of Greece – meet the convergence criterion, according to the EMI Report; the average yield on their ten-year government bonds outstanding was lower than the reference value of 7.8 % in the period from February 1997 to January 1998. The decline in long-term interest rates and the narrowing of interest rate differentials (see the table on page 25 and the chart on page 27) certainly reflect an improvement in the fundamentals, especially a dampening of price pressures and lower government deficits. On the other hand, interest rate developments in Europe have also been influenced by the international interest rate trend and by the expectations of market players concerning the participation of individual member states in monetary union. Especially in Italy, Portugal and Spain, whose interest rates have shown a greater degree of convergence only in the past few years, the improved prospects of their participation in Stage Three probably played a role.

5. According to the EMI Report, a growing degree of convergence has also been achieved in respect of exchange rate trends. Ten member states have been participating for two years or more in the exchange rate mechanism of the EMS. But the Italian lira and the Finnish markka have not completely met the criterion of two years' membership. Greece, Sweden and the United Kingdom were non-participants during the examination period.

In general, the currencies of the countries participating in the exchange rate mechanism kept relatively close to their respective central rate; only occasionally were the old fluctuation margins of ± 2 ¼ %, which, at the time the Maastricht Treaty was concluded, were regarded as the "normal fluctuation margins", exceeded upwards or downwards (see the charts on pages 29 and 30). There was a particularly close relationship between the Belgian/Luxembourg franc, the Deutsche Mark, the Dutch guilder and the Austrian schilling, as a result of which those currencies remained within the narrow fluctuation margins against each other throughout the two-year period. In the period prior to their entry into the exchange rate mechanism, the Italian lira and the Finnish markka were character-

Development of ERM currencies against the D-Mark*

Period: March 1996 to February 1998



* Excluding Greece, which joined the exchange rate mechanism for the first time on March 16, 1998. Calculated on the basis of the official Frankfurt spot rates. The shaded area represents a fluctuation margin of ±2¼%. — **1** The Finnish markka has been participating in the exchange rate mechanism since Oktober 14, 1996, the deviations prior to this date refer to the central rate as established upon entry. — **2** The Italian lira has been participating in the exchange rate mechanism since November 25, 1996, the deviations prior to this date refer to the central rate as established upon entry.

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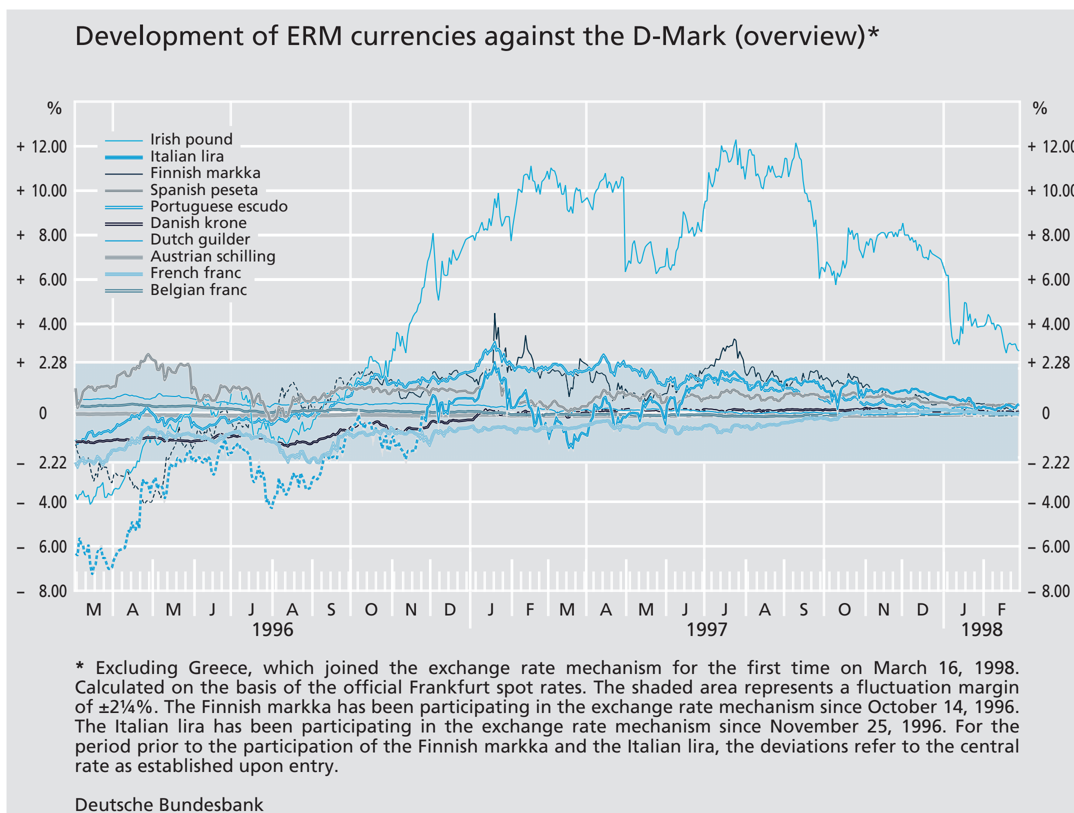
Development of ERM currencies against the D-Mark (overview)*



* Excluding Greece, which joined the exchange rate mechanism for the first time on March 16, 1998. Calculated on the basis of the official Frankfurt spot rates. The shaded area represents a fluctuation margin of ±2¼%. The Finnish markka has been participating in the exchange rate mechanism since October 14, 1996. The Italian lira has been participating in the exchange rate mechanism since November 25, 1996. For the period prior to the participation of the Finnish markka and the Italian lira, the deviations refer to the central rate as established upon entry.

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ised by pronounced downward deviations; following their entry, however, these currencies largely remained close to their central rates. There were major deviations and tensions in the case of the Irish pound, which for a prolonged period appreciated substantially against all other currencies participating in the exchange rate mechanism. With effect from March 16, 1998 the central rates of the Irish pound were raised by 3 % after the market rates had previously moved closer to the old central rates. Such an upward adjustment of the central rates does not contravene the Treaty.

6. Concerning the criterion of a sustainable government financial position, the member states offer a very disparate picture. Three member states – Denmark, Ireland and Luxembourg – recorded fiscal surpluses in 1997; 11 member states recorded deficits, which either met or were below the reference value for the deficit ratio of 3 % of GDP. However, the margin by which they were below the reference value was mostly rather narrow and in most cases was not achieved until 1997 (see the table on page 31). In six member states the deficit ratio was between 2.5 % and 3.0 %. Greece was the only member state to exceed the reference value, recording a government deficit of 4 % of GDP. In some member states the government financial position was aided in 1997, too, by transfer payments from the EU budget.

According to information given in the EMI Report, the deficit ratio of many member states in 1997 was influenced by measures

with a temporary effect (see the table on page 32). These measures were on such a scale in Italy, at 1% of GDP, and in France, at 0.6 % of GDP, that they were instrumental in enabling those countries to meet the reference value of 3 % of GDP in 1997.

Moreover, reduction of the deficit ratios in 1997 was favoured by falling long and short-term interest rates. This provided substantial relief, in particular, to those member states which had high debt ratios and whose interest rate level fell substantially on account of the markets' expectation of their future participation in the economic and monetary union (especially in Italy, Portugal and Spain).

In connection with the consolidation efforts the government capital expenditure ratios were reduced in most member states (with the exception of Greece, Ireland, the Netherlands and Portugal). While in 1997 government gross fixed capital formation in nine member states was higher than the government deficits (Austria, Denmark, Finland, Ireland, Luxembourg, the Netherlands, Portugal, Spain, Sweden), the deficits in the other six member states were higher than their investment levels (Belgium, France, Germany, Greece, Italy and the United Kingdom). This point, too, touches on the question of sustainability.

The debt ratio (see the table on page 33) was below the reference value in 1997 in only four member states (Finland, France, Luxembourg and the United Kingdom). Of the 11 member states in which the reference value

Public sector fiscal balances in the EU states *

As a percentage of GDP

Country	1991	1992	1993	1994	1995	1996	1997
Austria	– 3.0	– 2.0	– 4.2	– 5.0	– 5.2	– 4.0	– 2.5
Belgium	– 6.3	– 6.9	– 7.1	– 4.9	– 3.9	– 3.2	– 2.1
Denmark	– 2.1	– 2.1	– 2.8	– 2.8	– 2.4	– 0.7	0.7
Finland	– 1.5	– 5.9	– 8.0	– 6.4	– 4.7	– 3.3	– 0.9
France	– 2.1	– 3.9	– 5.8	– 5.8	– 4.9	– 4.1	– 3.0
Germany	– 3.1	– 2.6	– 3.2	– 2.4	– 3.3	– 3.4	– 2.7
Greece	– 11.5	– 12.8	– 13.8	– 10.0	– 10.3	– 7.5	– 4.0
Ireland	– 2.3	– 2.5	– 2.7	– 1.7	– 2.2	– 0.4	0.9
Italy	– 10.1	– 9.6	– 9.5	– 9.2	– 7.7	– 6.7	– 2.7
Luxembourg	1.9	0.8	1.7	2.8	1.9	2.5	1.7
Netherlands	– 2.9	– 3.9	– 3.2	– 3.8	– 4.0	– 2.3	– 1.4
Portugal	– 6.0	– 3.0	– 6.1	– 6.0	– 5.7	– 3.2	– 2.5
Spain	– 4.2	– 3.8	– 6.9	– 6.3	– 7.3	– 4.6	– 2.6
Sweden	– 1.1	– 7.7	– 12.2	– 10.3	– 6.9	– 3.5	– 0.8
United Kingdom	– 2.3	– 6.2	– 7.9	– 6.8	– 5.5	– 4.8	– 1.9

Source: European Monetary Institute, Convergence Report 1998. — * – deficit.

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Temporary effects on 1997 fiscal balances *

Country	As a percentage of GDP
Austria	0.5
Belgium	0.3
Denmark	0.1
Finland	0.6
France	0.6
Germany	0.2
Greece	0.2
Ireland	0.0
Italy	1.0
Luxembourg	n.a.
Netherlands	0.0
Portugal	0.2
Spain	0.1
Sweden	0.0
United Kingdom	0.5

Source: European Monetary Institute, Convergence Report 1998. — * Deficit-reducing measures which are effective for a limited period and which in some cases imply a burden on future budgets.

was not met, the debt ratio was marginally above the 60 % level in Germany and Portugal. Problems associated with government debt also exist in the case of member states whose debt ratio is below or close to the reference value of 60 %. Thus France and Germany display a pronounced expansionist tendency in respect of government debt (see the chart on page 35). Germany's debt ratio increased continuously up to 1997 – albeit marginally of late – to 61.3 % of GDP; its level of government debt was substantially inflated by German unification. In Greece, Belgium and Italy the 60 % ceiling was exceeded by a particularly large margin; in the latter two states it was more than twice as high.

According to the Maastricht Treaty, overshootings are only permissible provided that the debt ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace. Just how great the adjustment requirements still are in this respect is shown, firstly, by the fact that the level of government debt in many member states is still too high and in some cases fell only in 1997; on an EU average the debt ratio, following a sharp rise in the first half of the nineties, declined for the first time only in 1997 (to 72.1% of GDP, compared with 73.0 % in 1996). Secondly, a forward-looking examination needs to attach particular importance to whether a country has achieved a fiscal position which implies that its debt ratio can be reduced rapidly in the coming years. A close link exists in this respect between the government deficit and government debt, a link to which the EMI also referred in its Convergence Report. The higher the level of government debt, the lower its budgetary deficit needs to be or the larger the surpluses it has to generate must be if its debt is to be reduced to the reference value within a given period. The table on page 37 shows, by way of illustration, what fiscal balance in relation to GDP would be compatible with lowering government debt to the reference value in ten and five years, respectively, in the individual member states (based on an assumed growth in nominal GDP of 4 ½ % per year). In the EMI Report the convergence requirements are shown in addition based on the concept of the primary balance (fiscal balance less interest payments).

Public sector debt in the EU states

As a percentage of GDP

Country	1991	1992	1993	1994	1995	1996	1997
Austria	58.1	58.0	62.7	65.4	69.2	69.5	66.1
Belgium	127.5	129.0	135.2	133.5	131.3	126.9	122.2
Denmark	65.5	69.7	81.6	78.1	73.3	70.6	65.1
Finland	23.0	41.5	58.0	59.6	58.1	57.6	55.8
France	35.8	39.8	45.3	48.5	52.7	55.7	58.0
Germany	41.5	44.1	48.0	50.2	58.0	60.4	61.3
Greece	92.3	98.8	111.6	109.3	110.1	111.6	108.7
Ireland	95.3	92.3	96.3	89.1	82.3	72.7	66.3
Italy	101.5	108.7	119.1	124.9	124.2	124.0	121.6
Luxembourg	4.2	5.1	6.1	5.7	5.9	6.6	6.7
Netherlands	79.0	80.0	81.2	77.9	79.1	77.2	72.1
Portugal	67.3	60.1	63.1	63.8	65.9	65.0	62.0
Spain	45.5	48.0	60.0	62.6	65.5	70.1	68.8
Sweden	52.8	66.8	75.8	79.0	77.6	76.7	76.6
United Kingdom	35.6	41.8	48.5	50.5	53.9	54.7	53.4

Source: European Monetary Institute, Convergence Report 1998.

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Of the 11 member states with debt ratios of over 60 %, only four (Denmark, Ireland, the Netherlands and Sweden) recorded a public fiscal balance in 1997 which, were it maintained for, say, ten years, would be sufficiently favourable to bring indebtedness down below the reference value. In the other seven member states, by contrast, the deficits were still too high to enable the reference value to be achieved during this period, although the difference between the recorded deficit in 1997 and the fiscal balance necessary to achieve the target within a foreseeable period (budget gap) was less than ½ % of GDP in Austria, Germany and Portugal and even in Spain, at 0.7 % of GDP, was not much higher. In Belgium, Greece and Italy, on the other hand, the budget gap was in some cases significantly higher than 4 % of GDP. In those member states considerable government surpluses would have to be generated each year for a prolonged period for the reference value to be achieved within ten years. Judging by the convergence programmes presented so far, however, significant further deficits are expected in those member states up to the year 2000.

This model calculation – like the EMI's calculations – clearly shows that several member states have so far achieved only an insufficient reduction in their debt ratio and that considerable budget consolidation efforts still need to be made.

In the convergence debate the debt criterion and its implications for budget policy have frequently and unjustifiably been neglected.

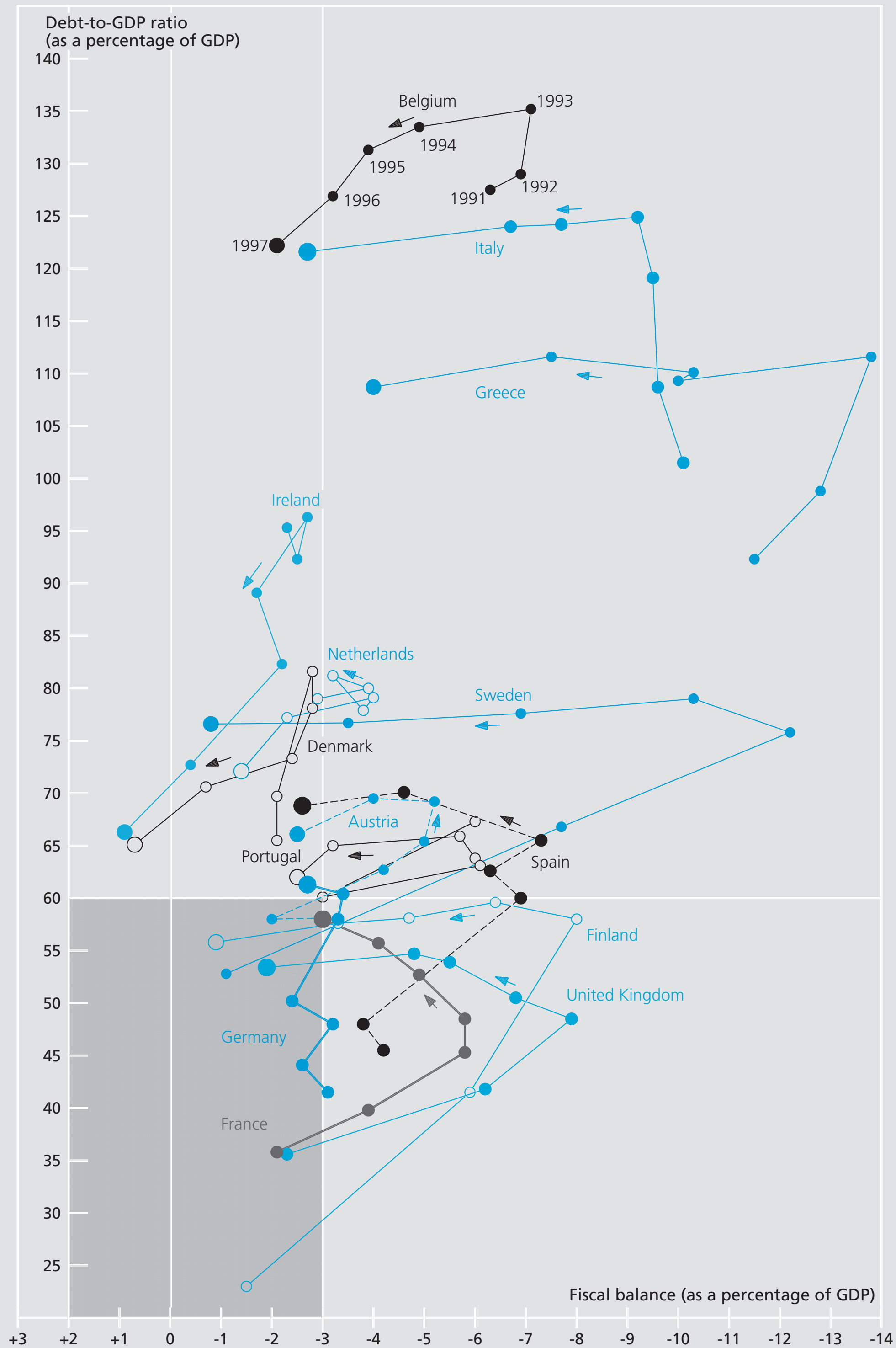
The Maastricht Treaty expressly demands that, if the reference value is exceeded, the government debt ratio – as mentioned – "is sufficiently diminishing and approaching the reference value at a satisfactory pace". Although the Treaty does not specify a time horizon, this cannot be taken as meaning that adjustment can be put off indefinitely. The adjustment period of ten years that is mostly assumed in this Opinion neither represents a new demand nor should be misinterpreted as representing a forecasting horizon. However, the budget gaps computed in the sample calculation illustrate graphically what adjustments are still required in some member states in order to meet the reference value stipulated in the Treaty within a period of ten years.

According to the EMI data, the weight of debt falling due in the short term (including variable-rate debt) is small in four member states (Denmark, Ireland, Luxembourg and the Netherlands), appreciable in a further six member states (Austria, Finland, France, Germany, Greece and the United Kingdom) – using different definitions in part – and considerable in Belgium, Spain, Portugal and Sweden; in Italy the weight of debt falling due in the short term (including variable-rate debt) is very great, so that the future government budgetary position will be affected to a particular extent by interest rate changes.

For the coming years the member states, according to the convergence programmes presented, aim to further improve their fiscal position. But the goals they have in mind are disparate. Thus, while Denmark, Finland, Ireland and Sweden – which in 1997 already recorded relatively favourable budgetary balances – intend to achieve surpluses by the year 2000, Austria, Germany, Italy, Portugal and Spain plan to reduce their deficits to between 1.5 % and 2.0 % of GDP. In France a lowering of the deficit to just under 1.5 % is currently envisaged by the year 2001. Belgium intends to reduce its deficit to 1.0 % by the year 2000 according to its current medium-term fiscal policy strategy. The Netherlands has presented no convergence programme going beyond the year 1998 but aspires in principle to achieve a balanced budget or a fiscal surplus. Especially member states with a very high debt level are expecting that a persistently declining interest burden ratio will contribute to improving their budgetary situation. The deficit-reducing effect of an assumed strengthening of economic growth is also included in their calculations. All in all, it is becoming evident that the majority of the member states will not achieve the aim of the Stability and Growth Pact in the medium term.

Some member states are susceptible to further risks in the medium-term perspective. For example, in France, Greece and Spain burdens are discernible in connection with remedial measures to cope with unprofitable public enterprises. In assessing the budgetary situation in Greece, Ireland, Portugal and Spain it needs to be remembered that these countries are currently receiving substantial net payments from the EU budget.

Above all, however, heavy burdens are to be expected on the government financial pos-


Government fiscal balances and debt-to-GDP ratios in the EU states *
Debt-to-GDP ratio
(as a percentage of GDP)
140
135
130
125
120
115
110
105
100
95
90
85
80
75
70
65
60
55
50
45
40
35
30
25
Belgium
1993
1994
1995
1996
1991
1992
1997
Italy
Greece
Ireland
Netherlands
Sweden
Denmark
Austria
Portugal
Spain
Finland
United Kingdom
Germany
France
Fiscal balance (as a percentage of GDP)
+3
+2
+1
0
-1
-2
-3
-4
-5
-6
-7
-8
-9
-10
-11
-12
-13
-14
* Excluding Luxembourg.
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ition of virtually all the member states in the longer term owing to demographic trends which will make themselves felt, in particular, in the pension insurance systems. The task facing the member states in this context is to alleviate the problems by means of fundamental reforms of the social security systems. In some countries, such as Finland, Ireland, the Netherlands, Sweden and the United Kingdom, certain provisions have already been made to tackle this problem by incorporating funded systems to a greater extent, but this is not the path that is being followed in general.

In a summary examination of the implications of the features listed above, it may be assumed that Denmark, Finland, Ireland, Luxembourg and the United Kingdom have achieved a fiscal position which can unreservedly be classified as being sustainable. In the case of a fairly large number of member states (Austria, France, Germany, the Netherlands, Portugal, Spain and Sweden) the consolidation measures need to be continued, the government spending ratio needs to be reduced and further radical reforms of the social security systems need to be undertaken in order to achieve a sustainable fiscal position. In Germany, that includes a binding regulation between the Federal Government and the Länder Governments concerning the assumption of responsibility for complying with the ceiling for the general government deficit.

Belgium has made marked consolidation advances in recent years; in the Bundesbank's estimation, however, they do not suffice to enable the extremely high debt ratio to be reduced by such a large margin that – also taking account of the fiscal plans known to date – substantial doubts about the sustainability of the government financial position would be dispelled.

Italy, too, has made considerable consolidation advances. However, the debt ratio has declined by only a comparatively small amount. In the Bundesbank's estimation, the advances made to date are insufficient to reduce the exceptionally high debt ratio by such a large margin that – also taking account of the fiscal plans known to date – substantial doubts about the sustainability of the government financial position would be dispelled.

V. Concluding assessment

1. Monetary union geared to sustained stability holds out the promise of major economic advantages. It will eliminate the exchange risk between the participating countries, lower transaction costs, enhance the efficiency of the labour, goods and financial markets, and thus provide good prospects of increased prosperity in Europe.

The individual countries have come a good way along the road to fulfilling the preconditions. Considerable progress has been achieved towards convergence during the past few years. Virtual price stability obtains in many member states, and inflation differentials have largely been levelled out. The interest rate criterion has likewise been met

Public sector budget gaps in EU states *

As a percentage of GDP

Country	Public debt in 1997	Fiscal balance in 1997	Budget gap in the event of		Required fiscal balance with	
			an adjustment period of ten years 1	an adjustment period of five years 1	an adjustment period of ten years	an adjust-ment period of five years
Austria	66.1	– 2.5	– 0.4	– 1.0	– 2.1	– 1.5
Belgium	122.2	– 2.1	– 4.4	– 10.4	2.3	8.3
Denmark	65.1	0.7	2.9	2.4	– 2.2	– 1.7
Finland	55.8	– 0.9	Debt-to-GDP ratio falls if the deficit-to-GDP ratio remains the same			
France	58.0	– 3.0	Debt-to-GDP ratio exceeds the 60 % threshold in the year 2002 if the fiscal balance of 1997 is maintained			
Germany	61.3	– 2.7	– 0.2	– 0.3	– 2.5	– 2.4
Greece	108.7	– 4.0	– 5.2	– 9.9	1.2	5.9
Ireland	66.3	0.9	3.0	2.4	– 2.1	– 1.5
Italy	121.6	– 2.7	– 4.9	– 10.9	2.2	8.2
Luxembourg	6.7	1.7	Debt-to-GDP ratio falls if the surplus-to-GDP ratio remains the same			
Netherlands	72.1	– 1.4	0.2	– 0.9	– 1.6	– 0.5
Portugal	62.0	– 2.5	– 0.1	– 0.3	– 2.4	– 2.2
Spain	68.8	– 2.6	– 0.7	– 1.6	– 1.9	– 1.0
Sweden	76.6	– 0.8	0.5	– 1.1	– 1.3	0.3
United Kingdom	53.4	– 1.9	Debt-to-GDP ratio falls if the deficit-to-GDP ratio remains the same			

Source: Own calculations (underlying data: European Monetary Institute, Convergence Report 1998). Owing to different assumptions, the figures shown in this table deviate slightly from those given in the EMI Convergence Report, especially as a uniform growth rate for GDP is assumed here, whereas the EMI figures are based on country-specific trend growth rates for 1998 estimated by the Commission. In addition, the fiscal outcome for 1997 is used here whereas the EMI figures are based on the forecast for 1998. — * It is assumed that the debt-to-GDP ratio is to decline to 60 % of GDP within the respective adjustment period. A nominal GDP growth rate of 4.5 % was used and the overall balance in 1997 was applied; no stock-flow adjustments were assumed. — **1** A minus sign means that the budget balance recorded in 1997 is not sufficient to reach the reference value within the adjustment period.

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in almost all cases. Not all the member states have been taking part in the EMS exchange rate mechanism for two years – as required by the Treaty – but exchange rate movements have become increasingly stable over that period.

Although the budget deficits have decreased significantly and were in all cases at or below the reference value of 3 % of GDP in 1997, there are still appreciable gaps in convergence in the area of public finance in a number of member states. The sharp decline in budget deficits in 1997 is, in some cases, attributable to one-off measures. Additionally, sufficient provision has not yet been made everywhere for the foreseeable future burdens. To date, most member states are not sufficiently geared to the future obligations arising from the Stability and Growth Pact, which requires them largely to have a budgetary position that is close to balance or in surplus from 1999 onwards, given a normal cyclical situation.

The high government debt in a number of member states represents a major burden; this applies in particular to Belgium and Italy, which have a government debt-to-GDP ratio that is twice as high as the reference value of 60 % provided for in the Treaty. The government debt ratio of Greece, at 108.7 %, is scarcely more favourable. An excessive level of debt will restrict the future scope for fiscal policy action and may easily come into conflict with monetary policy – especially if short-term borrowing or borrowing at variable rates of interest has a large share in financing. To that extent, an excessive debt ratio will represent a strain on, and risk to, future stability policy.

Bearing in mind the progress in convergence which has been achieved in many member states, and after giving due consideration to the remaining problems and risks, entry into monetary union from 1999 appears justifiable in stability policy terms. With regard to the requirement of a sustainable financial position, however, serious concern exists in the case of Belgium and Italy. This could only be eliminated if additional firm substantive commitments are undertaken.

2. Monetary union will entail far-reaching changes in the overall economic setting for economic policy and enterprises. Its implications are not restricted to the area of monetary policy. It will likewise have a significant impact on the goods and factor markets – just as, conversely, growth in the real economy that is as tension-free as possible will be a crucial factor in the success of monetary union.

The long-term gains in prosperity which are expected to come from monetary union will only be realised if wage and social policy adjust rapidly and comprehensively to the new conditions. What is indispensable, precisely against the backdrop of high unemployment in the majority of member states, is an adequately flexible response on the part of the goods and labour markets to differing trends in productivity and far-reaching market changes.

In monetary union, regional disparities might develop, the causes of which may be external or home-grown. The Maastricht Treaty provides for these to be overcome by internal efforts in the member states. The Maastricht Treaty rules out the assumption of debt among member states or by the Community (Article 104b). It should be made clear, however, that, given the currently envisaged degree of integration, additional transfer payments must not be a solution for regional or national problems either.

The long-term prospects of monetary union being successful are not determined solely by the convergence criteria enshrined in the Treaty being met, but rather, above all, by a satisfactory trend in the real economy in all parts of the union. This does not imply that the criteria at the forefront of the examination of the state of convergence are less important, however. On the contrary, the greater the shortcomings in meeting the criteria, and the less they can be regarded as safeguarded on an enduring basis, the greater are the risks to economic growth and employment in the monetary union and the less the expectations that are placed in monetary union can be fulfilled.

Monetary union is a project without historical parallel. It must not fail after it has been established. The economic fundamentals must be right upon entry into monetary union and be sustainable on a permanent basis. What is crucial in terms of credibility is that all who bear responsibility take their decisions in compliance with the often-declared principles. That is the only way that the requisite stability culture will be able to develop in Europe in future.

An economic policy which is consistent with the objective of stability, and a rapid adjustment to the new underlying conditions by the public authorities and the private sector are integral to the success of monetary union. Despite the significant progress which has now been achieved in these areas, there is still a need for considerable efforts on the part of the participating countries in order to create reliable preconditions for an enduring stability community throughout the currency area.

Entry into monetary union will have significant economic implications which must be given careful consideration when the decision is taken. The selection of the participants ultimately remains a political decision, however.