Out in the Cold?
Outsiders and Insiders in 1999:
Feasible and Unfeasible Options

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1. Introduction

As the ultimate date set for the commencement of the third stage of EMU and the adoption of the single currency approaches, technical, economic and political problems seem to grow in number and size. It is not always clear which of these are new and which instead existed already but were conveniently swept under the carpet and not talked about; which are real and which are instead a last minute invention to avoid an undesired plunge into the unknown. This short paper will consider only one of them: that of the regime governing the relationships between the single currency (or, in stage 3a, between the currencies of the member states fulfilling the necessary conditions for the adoption of the single currency) and the currencies of the member states with a derogation.

Unlike others, this is a precise problem: yet its implications are broader than those associated to the choice of an exchange rate regime, as it will also depend on its solution whether the status of derogation will be one of permanent limbo or one of transient purgatory. It is a real and in a way a new problem: for reasons to be unveiled by diplomatic historians, or because it was assumed that everybody concerned would be ready to sail on the single currency boat at the appointed time, or for sheer negligence, the drafters of the Treaty of Maastricht left a gap, which remained undetected until very

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recently under the cloud of dust raised by the ponderous academic and mediatic dispute on convergence criteria. Finally, it is a problem which has a political no less than an economic dimension, both for its institutional implications and for the complicated set of payoffs of the alternative solutions for the parties concerned.

Dealing with this specific issue in isolation, while neglecting all others that are being debated in this pre-EMU season, is relevant and legitimate if the following assumptions are accepted – no matter whether plausible or desirable:

(i) The third stage of EMU *will* start on 1 January 1999, without any *de jure* or *de facto* postponement. Hence the examination *ex* Article 109j will have taken place in the first half of 1998, based on the outturn for 1997, as decided at the Malaga Council.

(ii) The convergence criteria will remain unchanged, without any implicit or explicit relaxation. In particular, the discretion envisaged by Article 104c (2) will perhaps be used to assess the sustainability of the public debt to GDP ratios, but will not be applied to the deficit to GDP ratio which will be required strictly not to exceed 3% and even to be less than that for countries with high debt.

(iii) There will be a critical mass of member states fulfilling the conditions, sufficient for the start of the single currency: two or perhaps three larger ones (France, Germany, Spain perhaps) and a number of smaller ones.

(iv) The timing of the examination procedure and the strict application of the criteria will on the other hand prevent at least one and more probably two other larger member states (Italy, Spain perhaps), as well as some smaller members, from fulfilling the necessary conditions for admission. Initially such member states will have a derogation *ex* Article 109k (1) and (3) but they will strive to have the derogation abrogated, with the procedure of Article 109k (2).

(v) Neither member state with an opt-out clause – Denmark and the United Kingdom – will participate in the third stage, at least initially.

Taking this environment for granted, the paper will be thus organized. The next section will take a closer look at the question, with reference to the letter of the Treaty, to show how a potential

"Catch-22"[1] problem may arise for late-joiners and will examine whether the texts of the Treaty and the Protocol leave room for a solution. Section 3 will survey the conceivable options concerning the relationships between the countries admitted to participation in the third stage, better known as the insiders, or, in more familiar parlance, the "ins", and the countries in derogation, known as the outsiders, or the "outs". Explicit reference will be made to a number of proposals that have been advanced recently. Section 4 will set out the constraints under which the choice will be made and the costs and benefits of alternative solutions for the Euro-countries (the insiders) and for the less homogeneous group of outsiders. In the light of this analysis, Section 5 will first examine the *feasibility* of the alternative options, most of which do not pass the test of compatibility with institutional and political constraints; building on other proposals, it then sketches a possible solution which may be both institutionally feasible and economically viable. Section 6 will conclude.

2. Catch-22?

One of the criteria to be observed in order to be admitted to the third stage of monetary union requires "the observance of the normal fluctuation margins provided for by the Exchange Rate Mechanism of the European Monetary System ... without devaluing against the currency of any other Member State" (Article 109j (1), 3rd indent) and "without severe tensions for at least the last two years before the examination" (Article 3 of the Protocol on convergence criteria). The notion of "normal fluctuation margins" seems to have been benevolently stretched so as to allow the greater freedom permitted by the 15% margins introduced in August 1993. We assume that this

[1] From *Catch-22*, a novel by Joseph Heller. To be taken off combat duty on a US air force bombardier, a pilot decides to plead madness, because medical officers have to ground anyone who is mad. But the application to be grounded must be considered a proof that the applicant is sane. Hence the application either is not submitted or proves that the applicant is not mad. In either case the pilot must fly, even if he *is* mad.

is the case;[2] but the fact remains that "the requirement to be a member of the ERM remains an element of the Treaty".[3]

Member states not fulfilling the convergence criteria set out in Article 109j (1) shall have a derogation and be excluded from all rights and obligations pertaining to the adoption of the single currency (Article 109k, (1) and (3)-(5)). The position of a member state with a derogation will be re-examined at least once every two years or at its own request: if it fulfils "the necessary conditions on the basis of the criteria set out in Article 109j (1)", the derogation will be abrogated (Article 109k (2)): one of these conditions is, as we have seen, the observance of the normal fluctuation margins provided for by the ERM of the EMS for at least two years.

There seems to be little doubt however that, come 1 January 1999, the EMS itself will cease to exist. One of the two places where the EMS is mentioned in the texts of the Treaty in connection with the third stage is Article 23 of the Statute of the European Monetary Institute, dealing with the liquidation of the Institute and the transfer of all its assets and liabilities to the European Central Bank. Sections 2 and 3 state that

> "the mechanism for the creation of ECUs against gold and US dollars as provided for by Article 17 of the EMS Agreement shall be unwound by the first day of the third stage in accordance with Article 20 of that Agreement";
>
> "all claims and liabilities arising from the very short-term financing mechanism and the short-term monetary support mechanism ... shall be settled by the first day of the third stage".

It is moreover obvious that the European Central Bank is not a party to the Agreement of 13 March 1979 between the central banks of the member states, laying down the operating procedure for the EMS and cannot be bound by the obligations arising from it unless a

[2] See the formal opinion approved by the Council of the European Monetary Institute on October 7, 1994, later endorsed by the Ecofin Council, where it is deemed "advisable to maintain the present arrangements" (the 15% band). It is only recommended "that member countries continue to aim at avoiding significant exchange rate fluctuations" (European Monetary Institute 1995a); it is in principle possible, however, that "significant fluctuations", though within the wider band, be interpreted as a sign of "severe tensions" in the EMI and Commission Report on convergence.

[3] European Monetary Institute (1995b, p. 33).

new agreement is stipulated. Whence the question: How can "the normal fluctuation margins provided for by the Exchange Rate Mechanism" of the EMS be observed, if the latter is not there?

In an attempt to circumvent this problem, it may be surmised that: (i) the criterion set in Article 109j (1) does not require *participation* to the ERM, so that in principle also a non-participating country may observe "the normal fluctuation margins"; (ii) the requirement that before the third stage "each Member State shall treat its exchange rate policy as a matter of common interest" taking account "of the experience acquired in cooperation within the framework of the European Monetary System" (Article 109m (1)) is extended to member states with a derogation in the third stage (Article 109m (2)); (iii) according to Article 44 of the Statute of the ECB, the latter "shall take over those tasks of EMI which, because of the derogations of one or more Member States, still have to be performed in the third stage" and that the monitoring of the working of the EMS and the former functions of the European Monetary Cooperation Fund are among those tasks. So what, however? Though there are grins here and there, one is at pains to detect the cat. Participation may not be essential, but it is difficult to refer to normal fluctuation margins by analogy unless a central parity between the euro and each outside currency is defined. As for Articles 109m of the Treaty and 44 of the ECB Statute, they may be a useful legal and institutional framework for a new arrangement replacing the EMS, but in and by themselves they cannot provide the replacement.[4]

To sum up. If the ECB is not a successor of the central banks of the insider currencies as regards participation to the EMS, the latter will cease to exist. The Treaty, while silent on the exchange rate regime between the single currency and the currencies of the countries in derogation, sets on the other hand prescriptions of exchange rate policy which presuppose the existence of some exchange rate arrangement.

The existence of a problem is undeniable. It has been there all the time since the Treaty was initialled in 1991 and signed and ratified in 1992, but officials and academics seem to have discovered it only in 1995, when it was realized that monetary union may, after all, start in 1999 and that only a subset of EU members would be aboard at that date. The Madrid Council acknowledged its existence

[4] See also Kenen (1995).

and decided that "the future relationships between Member States participating in the Euro area and non-participating Member States will have to be decided prior to the move to Stage 3", but did not set any guideline when instructing the Ecofin Council, the Commission and the EMI to "study the range of issues raised" by the coexistence of outsiders and insiders.[5] The problem is one that has no obvious and no costless solution. A taxonomy of the conceivable options and of the likely constraints is preliminary to a discussion of political and economic feasibility.

3. A taxonomy of the options[6]

There are three major options, with variants within each: a) no exchange rate arrangements of any sort between the euro and the outside currencies; b) unilateral arrangements of exchange rate policy on the part of the outsiders; c) multilateral arrangements between the single currency and the outsiders.

a) *No exchange rate arrangement*

There are two variants.

i) – *No externally imposed discipline of any sort*, with the outsiders' currencies left to float without further requirements.

ii) – Instead of an exchange rate arrangement *a commitment to inflation targeting* on the part of all countries concerned. Oral tradition leads to identify this, at the official level, as a British view. With varying degrees of theoretical refinement, the same proposal has been advanced by Dewatripont *et al.* (1995) and by Persson and Tabellini (1996), who also envisage a system of multilateral monitoring of the targeting and possibly of multilateral decisions on the agreed targets at the EU and ECB level. The presumption behind it is that consistent inflation targeting would lead not only to inflation convergence, but also to exchange rate stability.

b) *Unilateral arrangements*

Setting an exchange rate target of its own currency with the euro, be it informal shadowing or formal pegging, would be left to

[5] Madrid European Council, 15 and 16 December 1995, *Presidency Conclusions*.
[6] See also Thygesen (1995).

the responsibility and the decision of the individual outsider, with no *involvement of the ECB with the decision and no change in the outsider's status*. In case of a speculative attack the outsider would bear the entire burden of defensive interventions; alternatively, it may change the rate at its own discretion. According to the Treaty, member states with a derogation would remain exempt from all rights and obligations of the single currency countries.

c) *Multilateral arrangements*

There are a variety of conceivable multilateral arrangements, ranging from the weakest to the strongest form of multilateral commitment.

i) – The weakest form of a multilateral arrangement is one in which the parity set by an outsider, together with the permitted fluctuation margins, is *recognized and accepted by the Euro-countries*, probably at the Ecofin level. It follows that any parity change by the former should be notified to and accepted by the latter. The ECB would undertake no explicit or implicit commitment to defend the parity, while the outsiders would remain exempt from the rights and obligations assigned by the Treaty to the outsiders. The parities would be set *bilaterally*, between the euro and each other outside currency ("hub and spokes"), without multilateral obligations between the outside currencies.

ii) – The mutual acceptance of a parity may be strengthened by other commitments of the parties involved. It has thus been proposed that the outsider near to qualification be granted an associate status in the ECB, with participation to the Governing Council (and not only to the General Council) of the ECB, without voting rights and hence without participation to the management of EMU until it has fulfilled all the other conditions (De Grauwe 1995).[7] A parallel proposal (Thygesen 1995, Gros 1996) is that the bilateral exchange rate arrangement between the euro and an outsider currency be accompanied by some form of conditionality. The mem-

[7] According to the Statute of the European Central Bank, the governors of the central banks of member states with a derogation are not members of the Governing Council (Article 43.4). They are members of the General Council (Article 45), which has general (and generic) advisory tasks but no say on the conduct of the common monetary policy (Article 47).

ber state in derogation who is party to an exchange rate agreement, though having no rights, would be required to accept some of the most relevant obligations arising from membership, such as following the monetary policy directives set by the ECB, being part of a unified payments system, pooling a portion of the foreign exchange reserves in the ESCB, submitting to the sanctions of the excessive deficits procedure.[8] All this would be officially acknowledged by the Union in conjunction with a convergence programme setting a deadline for the fiscal criteria. Observing the programme would entitle the outsider to supporting (but discretionary) interventions of its currency's parity from the ECB. To emphasize the asymmetry of the arrangement, while the ECB interventions would be fully sterilized, the outsider would commit not to sterilize its own interventions.[9]

iii) – The strongest form of multilateralism would be provided by the rebuilding of an EMS-style agreement, with a grid of mutually consistent central parities and permitted floating margins around them and, especially, with support facilities and with the definition of intervention obligations.

4. Constraints, incentives and disincentives

The choice between the options listed above cannot be made on grounds of pure economic theory – even supposing that economic theory can point to an unambiguous choice. There are institutional and political constraints to be taken into consideration, as well as the incentives and disincentives for the Euro-countries and for the individual outsiders implicit in any solution.

[8] Article 109k(3) of the Treaty lists the other Treaty articles not applying to member states with a derogation; Article 43.1 of the Statute of the ESCB and the ECB lists the articles of the Statute that "shall not confer any rights or impose any obligations" on the same member states. The most important obligations regard the sanctions for excessive deficits, the submission to the decisions and instructions of the ECB regarding monetary policy, the pooling of part of the foreign exchange reserves and the conduct of foreign exchange operations. The rights are those arising from participation to the ECB and to its decision-making bodies.

[9] To enhance the credibility of the exchange rate target it is suggested that the outsider sets up a currency board (Gros 1996).

A *first constraint* is that later admission to the common currency cannot be made either impossible or subject to a degree of *restrictive* discretion which finds no place in the letter or the spirit of the Treaty. The only degree of discretion present in the Treaty is *permissive* and regards the evaluation of a member state's compliance with the debt and deficit criteria. No discretion, either restrictive or permissive, is allowed in the case of the inflation and the interest rates criteria. As for as the exchange rate criterion, it is likely that discretion will be applied in the sense of stretching the interpretation of "normal" from the earlier "normal" 2.25% ERM margins to the enlarged 15% margins, while there may be a margin of restrictive discretion for the definition of "severe tensions" of Article 3 of the Protocol on convergence criteria. Two consequences follow from this constraint. As a way *must* be found to remove the "catch-22" described in Section 2, a minimum requirement is that Article 109 j (1), 3rd indent be interpreted (as is possible) as not strictly requiring *participation* to the Exchange Rate Mechanism of the European Monetary System, for the good reason that the latter is no longer there. Second, whatever criterion is chosen regarding the ousiders' exchange rate, it must be clear-cut (except perhaps for the "severe tensions") and not lend itself to discretion.

A *second constraint* is that there seems to be consensus that formal Treaty changes, as regards Title VI on "Economic and Monetary Policy" and the Protocols pertaining to that Title, should be avoided,[10] though, as we shall see, a minimal addition may be required. There are several reasons for this. It is feared that, once the possibility of revisions is admitted, it would be difficult to confine the changes to the exchange rate criterion in the case of later entrants: everybody is wary of opening a Pandora box the contents of which are difficult to foresee.[11] The formal process of revision and of ratification at the national level is cumbersome and time consuming

[10] It is useful to remember in this connection that the agenda of the Intergovernmental Conference starting in March 1996 will be devoted to political union and to the EU institutions and will not include economic and monetary union.

[11] Some can already been foreseen: it is a known British view that, in the 1998 decision regarding which countries qualify for entering the third stage in 1999, participation to the ERM should not be considered as a necessary condition if the other convergence criteria are fulfilled.

and in some countries it may open the way to renewed referendums. If this constraint holds, it follows that, to be *feasible*, any solution to the problem we are considering must be such that it can be presented as descending from a legitimate interpretation of the existing text: at most, it should require no more than an additional protocol clarifying and interpreting the existing text.

Coming to *incentives and disincentives*, consider first the *insiders' position*. It is easy to detect there one powerful disincentive and one equally powerful incentive to establish a formal relationship between the euro and the outsiders' currencies. The disincentive arises from the obvious interference of an exchange rate policy with monetary policy. The newly born European Central Bank will have to build and establish its reputation in the pursuit of price stability – the "primary objective" which the Treaty (Article 105) and the Statute (Article 2) assign to it: formal independence and the adoption of the Bundesbank model in its Statute help, but cannot fully surrogate something which is not there yet and which only consistent behaviour over the years to come can provide. It follows that the ECB will, at least at the beginning, enjoy less freedom in the conduct of monetary policy than a central bank with an established reputation: a sudden increase in the money supply can be afforded by the latter, as experience shows that the situation will be kept under control, but not by the former, which has no track record that can be relied upon. Entering an exchange rate arrangement introduces an element of potential or actual endogeneity of the money supply and may as such jeopardize the task of the ECB in maintaining price stability and weaken its reputation at the outset. That there is a problem there is confirmed by the misgivings that were aroused by Article 109 of the Treaty, which assigns to the Council the power to "conclude formal agreements on an exchange rate system for the ECU in relation to non-Community currencies", or, in the absence of such a system, to "formulate general orientations for exchange rate policy in relation" to one or more non-Community currencies.

Opposed to the monetary authorities' disincentive is the request coming from the insiders' tradable sector to keep the outsiders' currencies under control by compelling them to stick to an exchange rate target. The agreed assumption is that, if the outsiders' currencies are left loose, their nominal exchange rates' movements will not be

stationary, but will occur along a depreciating trend. The prediction that *in the long run* these movements will be offset by parallel inflationary developments and will thus have no effect on the real exchange rate is of meagre confort. As not only the dollar experience but also the recent experience of the lira, the peseta and the pound show, sticky goods and labour prices (sometimes made stickier by successful incomes policies, as in Italy) take a very long time to catch up with volatile financial assets' prices: the long run may be very long and lot of pain may be caused in the transition.

Tables 1-4 are evidence of the insiders' interest that a way be found to peg down the external value of the outsiders' currencies. German exports to the four major potential outsiders are 21% of the total and 36% of exports to EU countries; imports from the four are respectively 20% of the total and 35.5% of imports from the EU. Over 32% of Italian exports go to France and Germany representing over 10 and 9% of those two countries' imports. For Italy, Spain and Sweden the nominal effective depreciation occurred between the third quarter of 1992 and the third quarter of 1995 caused an equal or greater real depreciation in terms of unit labour costs and, for Italy, a sensible though smaller depreciation in terms of PPI. The (non transitory) increase in competitiveness allowed a faster rise of exports in the depreciating countries and an absolute and relative improvement in profit margins as evidenced by the comparison between the real ULC and the real PPI exchange rates.[12]

Coming to the *outsiders*, there are deep differences between those willing to enter the third stage of monetary union, unable to do so at the outset because they do not fulfil the criteria, but anxious to gain later admission, on the one hand, and at least one of the two countries that have asked for and obtained an opt-out clause for the third stage. Of the latter, the UK, assuming that its present position remains unchanged, clearly has no incentive to participating to a

[12] History provides further evidence of the persistence of the real effects of nominal appreciations and depreciations. Between 1923 and the stabilization of 1926 with respect to the gold-linked currencies, the lira underwent a nominal effective depreciation of some 23%, accompanied by an almost equal real effective depreciation. The same happened to the French franc. Conversely, after 1931, when the pound sterling abandoned gold while the lira maintained the gold parity, the Italian currency appreciated nominally *and* in real terms by some 25% in three years.

TABLE 1

GERMANY – SHARES OF FOREIGN TRADE 1994

	Exports		Imports	
	on total	on EU	on total	on EU
Italy	7.6	13.1	8.4	15.1
Spain	3.2	5.5	2.8	5.0
Sweden	2.2	3.8	2.3	4.1
UK	8.1	13.9	6.3	11.3
Total	*21.1*	*36.3*	*19.8*	*35.5*

Source: Deutsche Bundesbank, *Monthly Report.*

TABLE 2

ITALY – SHARES OF FOREIGN TRADE 1994

	Exports			Imports	
	on total	on EU	on imports	on total	on EU
France	13.1	24.5	10.5	13.6	24.1
Germany	19.0	35.6	8.7	19.2	34.2

formal exchange rate agreement between the euro and the outside currencies. It is natural that a country fulfilling the criteria but unwilling to enter the third stage in the foreseeable future is uninterested in the problems that may make later entry of non-performers more difficult. Second, the UK's traditional mistrust for fixed or semi-fixed rates arrangements is well known and was strengthened by its short-lived experience in the ERM. But there is perhaps a third and less obvious reason for this attitude – the purpose of assuming a leadership of the outsiders, expressed with some clarity by the following statements of the UK prime minister:

"... when a single currency proceeds, and some countries are outside [the explicit reference is to "strongly pro-European nations which feel the European ethic very strongly – like Portugal or Spain or Italy"], some of

TABLE 3

CHANGES IN EFFECTIVE EXCHANGE RATES 1995.3/1992.3

	Nominal	Real/ULC *	Real/PPI *
France	11.9	8.7	1.6
Germany	15.0	16.5	4.0
Italy	–26.4	–26.3	–19.6
Spain	–15.9	–16.0	..
Sweden	–20.3	–24.1	..
UK	–11.2	–6.8	–11.5

* Manufacturing.
Sources: European Commission and Bank of Italy.

TABLE 4

EXPORT GROWTH IN MANUCTURING 1992-1994

	Infra-EU12	Extra-EU12
France	–2.5	3.6
Germany	–6.3	6.1
Italy	2.2	14.2
Spain	8.7	17.8
UK	3.6	12.3
EU 12	0.1	9.2

Source: European Commission.

the smaller countries will look for leadership outside the single currency as well as within it. In the debates leading up to a single currency they will look for leadership of their position. Their points need to be put in the debate as well. And I think that the United Kingdom has a responsibility that I wish to see discharged to put their views into the debate".[13]

The Danish position is different. Whether Denmark uses its opt-out clause or not, it is likely that it will want to keep a strict link between the krona and the euro,[14] just as it has always been its policy to keep a strict link between the krona and the DM irrespective of the permitted margins of fluctuations.

[13] Interview to John Major, *Financial Times*, Weekend 1-2 July 1995.
[14] On this see Thygesen (1995).

The outsider *malgré lui* has an obvious incentive that the door be kept wide open for later admission. The first reason is political. Countries remaining in derogation in 1999 will mostly be – to use Mr Major's apt expression – "strongly pro-European nations which feel the European ethic very strongly": sensing the initial exclusion as a diminution, they will set a favourable verdict at their appeal trial as their major target, and will therefore be anxious to remove any external obstacles to later admission that cannot be imputed to their domestic behaviour. When writing loss functions for these countries, a term capturing the political cost of non-entry[15] ought to be included.

There are then economic reasons for wishing to establish a tie with the euro that would help to make derogation appear as a transitory status. The actual and expected volatility of a freely floating outside currency would be reflected in the interest rates differentials with the euro and, initially, with the currencies included in it. Even irrespective of the compliance with the exchange rate criterion, this would negatively affect two other convergence criteria: the one regarding the highest permitted spread (2%) of the long-term interest rate level on that of the three best performing member states in terms of price stability;[16] and the one regarding the deficit for countries with a high debt, whose excessive deficit is largely, if not entirely, due to high interest rates.[17]

Are there disincentives for this group of countries to establish the conditions allowing them to join EMU, though at a later stage? If there are, they are weak in comparison with the incentives. Of course, an exchange rate arrangement with the euro would make attempts at engineering competitive devaluations more difficult and more costly. But would any of those countries want to engage in such attempts? Italy, Spain and Sweden have already achieved a very good competitive position: the perception that the inflationary cost of further nominal depreciations would outweigh any additional benefit they may obtain in terms of net exports finds its expression in the domestic policies pursued since 1994. Reluctance to undertake further efforts towards fiscal consolidation may be a more powerful motivation for a cool attitude towards late entry. But, apart from the fact that this attitude is not confined to prospective outsiders, an exchange rate arrangement with the euro may look attractive *per se* and would have the advantage of not preempting the option of late entry.

[15] As in Obstfeldt (1994) for the alternative of abandoning a fixed exchange rate in a currency crisis.

[16] This criterion may produce paradoxes. As appears from the data in EMI (1995b), in 1995 the best performing country in terms of price stability was Finland, with an inflation rate of 1.2%. Finland's long-term interest rate was however 9.2%, lower only than that of four countries out of fifteen. As a result, the reference long-term interest rate was not only higher than that computed with reference to the third best performer in terms of inflation, but also higher than that computed with reference to the average of the *nine* best performing countries.

[17] The trend value of the general government deficit in Italy in 1997 is projected to be 6.4% of GDP – the algebraic sum of 9.9% interest expenditures and of a 3.5% primary surplus. On the relevance of this point see Gros (1996).

5. Unfeasible and feasible options: a proposal

Acceptance of the two political-institutional constraints set at the beginning of the previous section – open door to late entrants fulfilling the "domestic" convergence criteria and no Treaty change except perhaps minimal additions to interpret the clause on the exchange rate criterion – severely narrows the subset of feasible options with respect to the wider set of options listed in Section 3.

If there were *no arrangement* of sort between the euro and the outsiders, entry to the latter would be barred as long as the criterion imposing "the observance of ... normal fluctuation margins" remains in place. A European system of jointly announced, centrally monitored (by the ESCB) and centrally sanctioned (by the Council) *inflation targets*, as in Dewatripont *et al.* (1995) and, more elaborately, in Persson and Tabellini (1996) would represent no adequate substitute, for formal as well as for substantive reasons. The proponents of this solution fail to consider the problem of a member state in derogation applying, or being examined, for an abrogation of the derogation and for full participation to the third stage; they rather seem to envisage the (different) issue arising from the need to establish a peaceful coexistence between the euro and a number of currencies destined to remain indefinitely in an outsider status. If the incentive for outsiders (except those with an opt-out clause) to be allowed into the Euroclub at the earliest is recognized, it must be realized that the Treaty already sets an inflation target for them, and a sanction for missing that target: the target is "an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than $1^1/_2$ percentage points that of, at

most, the three best-performing Member States" (which will presumably belong to the euro-area);[18] the sanction is the refusal of admission as long as that objective is not achieved – a cost for the willing outsider that, as noted, should find a place in the relevant loss functions. Since the Treaty sets both, an inflation objective and an exchange rate clause, proposing to concentrate on the former and forget the latter is tantamount to asking that one of the convergence criteria be cancelled in the case of late admission; or, alternatively, to accepting permanent exclusion of those who are left out in 1999. The answer that the exchange rate criterion is redundant, as inflation targeting would deliver nominal exchange rate stability, is moreover open to question, apart from its incompatibility with the letter of the Treaty *as it is*: true, inflation targeting would be incompatible with an attempt to engage in competitive devaluations; but it would not prevent the volatility inflicted upon outside currencies by external shocks (such as the movements in the exchange rate between the DM – today – or the euro – tomorrow – and the dollar).

Unilateral arrangements with the individual outsider setting its exchange rate with the euro at its own discretion, are not a feasible solution either, because of an inherent contradiction with the Treaty requirements. If the observance of "normal fluctuation margins" is a condition for admission, there must be recognition by the monitoring and decision-making bodies of the Union – hence by the Commission, the ECB and the Council – of a central parity around which margins are permitted. Recognition implies that the exchange rate target cannot be set, and changed, at the outsider's own discretion. If this were the case and unilateral discretion were allowed, the outsider near to fulfilling the other convergence criteria would have an incentive to set a central rate well above the current market rate, on the assumption that this would be the rate at which its currency is irrevocably locked to the euro when the derogation is abrogated: the outsider could in this way gain an improvement of its competitive position when it enters the third stage.

A feasible solution, if it exists, must thus be sought within the subset of *multilateral arrangements*. Also in this case, however, the available options must be pruned down in view of a realistic consideration of constraints, incentives and disincentives.

[18] Article 1 of the Protocol on the convergence criteria. It is however not impossible that an outsider – say Finland – has an inflation rate lower than that of the insiders, which would then have to be considered in the reference average.

Consider first the strongest form of multilateral arrangement which consists in the setting up of a new EMS, with a multilateral exchange rate mechanism including the euro and at least some of the outside currencies. It is first to be noted that it is not obvious how such an arrangement can be made consistent with the Treaty provisions. The EMS originated from a Resolution of the European Council: it was decided that "a European Monetary System (EMS) will be set up on 1 January 1979", that the ecu "will be at the centre of the EMS", that "each currency will have an ECU-related central rate", that these central rates would be used to establish a grid of bilateral rates with fluctuation margins of $\pm 2.25\%$ (with an option of 6%); intervention rules were defined; a very short-term facility of an unlimited amount for the interventions was established. The Resolution then requested "the central banks of Member States to modify their Agreement of 10 April 1972 on the narrowing of margins of fluctuations ... in accordance with the rules set forth" by the Council.[19] On 13 March 1979 the central banks of the member states signed an agreement "laying down the operating procedures for the European Monetary System" *in execution* of the Resolution of the Council. Could the same procedure be followed now, when one of the parties involved is the ECB?

As we have seen, Article 109 of the Treaty empowers the Council to "conclude formal agreements on an exchange rate system for the ECU [now euro]" or to formulate general orientations for an exchange rate policy: these provisions, however, strictly apply to agreements and policies "in relation to non-Community currencies". Article 7 of the Statute of the ESCB, on the other hand, requires that the ECB shall not "seek or take instructions from Community institutions or bodies". Formally, therefore, it follows from these two provisions that a Council resolution setting up a formal exchange rate agreement for the euro in relation to other Community currencies cannot be binding for the ECB and that an agreement between the ECB and the outsiders' central banks cannot be made to descend from a Council resolution. Lawyers may probably find a solution to this conundrum: the most straightforward – and one that may be needed anyway, as we shall see presently – would be an additional Protocol of one article, stating that the provisions of Article 109 also apply to the currencies of member states with a derogation.

[19] See European Communities, Monetary Committee (1979). The date of 1 January 1979 for setting up the EMS was postponed to 13 March.

Behind formal difficulties, however, there remains a more substantive problem. Major central banks participating to the ESCB are unwilling to accept a commitment to compulsory interventions in support of outside, and hence, almost by definition, weaker currencies. A volume could be filled with quotes from the Bundesbank to that effect, not only after the experience of the EMS crisis of 1992-93, but since the very start of the EMS;[20] remembering what was already said on the naturally weaker position of the ECB in terms of reputation, there is little need to elaborate on this issue. Furthermore it may be objected with some justification that a distinction should be made between outsiders in different positions as regards the degree of fullfilment of the convergence criteria. All in all, therefore, it is difficult to consider a reconstructed EMS-style exchange rate mechanism between the euro and the outside currencies as a likely prospect, irrespective of its rank in terms of abstract desirability.

We are then left with weaker forms of multilateral arrangements, of which there are esentially two: the simple bilateral setting of a parity between the euro and individual outsiders' currencies, without any formal change in the outsider's status and without any formal commitment on the part of the ECB or the euro-countries; or a more structured arrangement, strengthened by a limitation of the outsiders' exemption from insiders' obligation compensated by the acquisition of conditional right and conditional support.

The first alternative is clearly very fragile. The exemption from obligations would increase the outsider's institutional isolation and hence the intrinsic weakness of its status; with a limited amount of foreign exchange reserves available to its central bank the outside currency's peg would be easy prey to any speculative attack.[21] Thus, though a feasible option in terms of constraints, it would not be a viable one. Considering moreover that any devaluation of the mutually agreed rate would delay entry into the single currency group and that this would in turn make the currency more exposed to further speculative attacks, this solution may eventually turn out to be

[20] See Eichengreen and Wyplosz (1994) and the text of a letter written by the President of the Bundesbank, Emminger, to the German government in 1979, stating that the Bundesbank reserved the right of limiting its interventions in support of other EMS currencies.

[21] Persson and Tabellini (1996) show that the arrangement discussed in the text, irrespective of its fragility, may be highly destabilizing and have high welfare costs for the outside country.

inferior to outright floating with the implicit acceptance of permanent exclusion.

In the end, a more structured set up (which however does not go all the way to a new EMS) appears to be the only option left. It is an option, however, that needs to be shaped carefully, relying on flexibility and discretion, more than on overly rigid arrangements, when considering the rights and obligations of the parties involved: some pruning is required also in this case.

Thus, conferring upon the willing outsider the status of associate member of the ECB, with the right to participate to the Governing Council without voting rights, would require a cumbersome revision of the Statute of the ESCB and the ECB – and would probably represent an irritant for the full participants. The President of the ECB and the presidents or governors of the insiders' central banks will meet in the General Council and will – it is to be presumed – talk to each other. It is interesting to remember in this connection that one of the tasks of the General Council is to "contribute to the necessary preparations for irrevocably fixing the exchange rates of Member States with a derogation against the currencies, or the single currency, of Member States without a derogation" when it is decided to abrogate a derogation and the Council adopts the rate of conversion.[22]

Though to a lesser extent, similar objections apply to a formal agreement (as envisaged by Gros 1996) imposing on the outsider all obligations and the Statute in case of full participation to monetary union, ranging from full acceptance of the ECB monetary policy, to the irrevocable fixing of the exchange rates, to submission to the excessive deficit procedure, and the compliance with a pre-set convergence programme. Official acknowledgement by the Union, it is surmised, would help the outsider to defend the exchange rate and enhance its credibility with favourable effects on the interest rate, also because it is "likely that if there were a totally unjustified speculative attack, the ECB would help the country concerned".[23] It is unclear what would be the status of such agreement in the frame of European legislation and who should be the party to it – whether the ECB, whose competences do not however extend to fiscal matters, or a Community body like the Council, which however includes also the outsider and cannot in any case issue instructions to the ECB, or both.

[22] Article 47.3 of the Statute and Article 109l (5) of the Treaty.

[23] Gros (1996, p. 59).

What is to be retained from this proposal is the idea of a conditional arrangement.

To make it precise and to avoid institutional problems, however, an additional protocol "on exchange rate agreements for the Euro in relation to Community currencies of countries with a derogation" is probably required. The Protocol, as suggested above, need only say that "the provisions of art. 109 (1)-(3) are extended to Community currencies of Member States with a derogation" and that the condition of Article 109j (1), 3rd indent (on the exchange rate criterion) is satisfied for late entrants, by participation to an agreement stipulated in the frame of Article 109. This extension would offer several advantages:

flexibility, as Article 109 leaves the content of a potential exchange rate agreement unspecified and the Council may moreover choose between formal agreements for the euro in relation to outside currencies and the mere formulation of general orientations for exchange rate policies;

guarantees for the insiders, as, to conclude formal agreements, the Council must act "unanimously on a recommendation from the ECB or from the Commission, and after consulting the ECB": the unanimity requirement should be sufficient to dispel the possible misgiving aroused by the presence of outsiders in the Council;[24]

reversibility, as "the Council may, acting *by a qualified majority*, on a recommedation from the ECB or from the Commission, and after consulting the ECB ..., adopt, adjust or abandon the central rates of the [euro]".

Considering the insiders' aversion towards a multilateral EMS-like system and the variety of the situations of potential outsiders, the arrangement which an extended Article 109 would allow is best conceived as a sum of bilateral agreements with some individual outside currencies: but not with all of them both, because there may be countries unwilling to enter an exchange rate agreement with the euro and more importantly, because the Council may wish to exercise its discretion in deciding which countries are sufficiently near to the fulfillment of the fiscal and inflation convergence criteria. Each agreement would set the central rate between the euro and the individual currency and define the permitted fluctuation margins. It may introduce conditionality tailored to the situation of the individual country, on the basis of Commission and ECB recommendations and include a convergence programme, monitored by the Commission and the ECB. Though the agreement would be the responsibility of the Council, the ECB would be entrusted with judgemental discretion as far as interventions are concerned, with the understanding that support should be provided if the attack on the outside currency is of a purely speculative nature, but not if it originates from the outside country's underperformance under the convergence programme. Motivated interruption of the ECB support and the Council's majority decision to abandon the agreed central rate and possibly to rescind the exchange rate agreement altogether would represent sanctions far more effective than the excessive deficit procedure.

[24] This guarantee may, if anything, go too far, if there is one member state which is hostile *in principle* to exchange rate arrangements.

This division of tasks would respect both the Council's competences and the ECB independence. The insiders' central banks may of course object to the presumption that the ECB should intervene in some instances. They should however be reminded that it may be wrong to compare this regime with one in which the ECB is an ivory tower, the occupants of which can afford to be indifferent to what happens in the outside suburbs. The outsiders' attempt to defend their exchange rates, whether by means of interventions and/or by means of interest rate changes would in any case affect the ECB monetary policy.[25] If on the other hand the outsiders allowed their exchange rate to depreciate, political pressures would mount from the inside countries for the ECB "to do something about it". An unconditional and unqualified hostility towards *any* exchange rate arrangement would be a mistake.

6. Conclusions

The solution sketched above may not represent the first best in terms of pure economic theory. But pure economic theory is perhaps not equipped to solve the difficulties arising when so many institutional and political constraints are at work: the existence of a Treaty containing contradictory provisions, which can at most be adapted but cannot be removed; the undeniable right of the countries that cannot enter the third stage in 1999 to have a chance left for later

[25] See Thygesen (1995).

admission and the incentive that most of them have to enter the single currency group; the mistrust of the 1999 insiders towards arrangements implying obligations that may jeopardize the commitment to price stability of the newly born European central bank.

The "catch-22" problem for the outsiders created by a somewhat careless drafting of the Treaty has thus neither an easy nor an ideal solution. Of the options examined, some would require extensive Treaty changes and are as such impracticable; others would make the insiders' life easy, but would in practice bar access to outsiders and would thus be in contrast not only with the Treaty, but with the very spirit inspiring the European construction; still others may meet the outsiders' requirements but would be unacceptable to outsiders. Whence the need for a workable compromise. The ingredients of the one examined in this paper are: a short additional Protocol interpreting the exchange rate criterion for countries in derogation and extending to the latter the scope of article 109; the possibility for the Council to conclude bilateral exchange rate agreements for the euro in relation to individual outside Community currencies subject to convergence conditionality; when interventions are needed, power to the ECB to discriminate between transitory speculative crises and crises originating from policies that are inconsistent with convergence; for the outsider failing to meet the conditions included in the agreement sanctions consisting in the interruption of ECB support and in the Council's decision to abandon the agreed central rate.

There may exist better solutions: to belong to the feasible set, they must be compatible with the recognized constraints. Given the latter, the academic chase for a best solution is not of much help. But the slow and uncertain motion of the official diplomatic game does not help either.

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