Conclusions of the Dublin European Council: report on the preparations for the third stage of EMU (13–14 December 1996)

Caption: On 13 and 14 December 1996, the Dublin European Council adopts the report of the Ecofin Council, drawn up in close cooperation with the European Commission and the European Monetary Institute (EMI), on the technical and legal preparations required for the transition to the third stage of Economic and Monetary Union (EMU) on 1 January 1999.
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European Council in Dublin (13 and 14 December 1996)
Conclusions of the Presidency

[...]

Economic and Monetary Union

1. Economic and Monetary Union

The European Council welcomes the further decisive progress which has been made in the preparations for EMU, which will begin on 1 January 1999.

- The structure of the new Exchange Rate Mechanism has been agreed.

- The urgent aspects of the legal framework for the use of the euro have been finalized for early adoption.

- The principles and main elements of the Stability and Growth Pact for ensuring budgetary discipline in EMU have been agreed.

The European Council therefore urges the institutions, public authorities and economic agents to intensify their preparations for the starting date of 1 January 1999.

The European Council welcomes the excellent Report by the ECOFIN Council (annexed) on preparations for Stage 3 of EMU, which is fully in line with the conclusions of Madrid and Florence, and it pays tribute to the contributions, in their respective fields of competence, from the Commission and the European Monetary Institute (EMI). The contents of this Report are subject to Parliamentary reservations.

In particular the European Council:

- endorses the conclusions on the new exchange rate mechanism (ERM2) as proposed by the ECOFIN Council and the EMI. It invites the ECOFIN Council to prepare for the European Council in June 1997 a draft Resolution setting out the fundamental elements of the ERM2, following the precedent set in 1978 in relation to the present ERM. The EMI is invited to prepare, in parallel, a draft for an inter-central bank agreement, for submission to the European Central Bank and the central banks of the Member States not forming part of the euro area.

- underlines the need to ensure durable budget discipline in Stage 3 of EMU and welcomes the agreement reached on the Stability and Growth Pact. It requests the ECOFIN Council to examine intensively the Commission proposals for two Regulations, one on the strengthening of the surveillance and co-ordination of budgetary positions and the other on speeding up and clarifying the implementation of the excessive deficit procedure. It invites the Commission to put forward a proposal for a Regulation on non-participating Member States. Furthermore, it invites the ECOFIN Council to prepare a draft Resolution on the Stability and Growth Pact to be adopted by the European Council in June 1997, recording the commitments of the Member States, the Commission and the Council to a strict application of the Treaty and the legal provisions on budgetary stability. The European Council notes that after it has adopted the Resolution, the Council will adopt the respective Regulations.

- welcomes the agreement by the ECOFIN Council on the two Regulations establishing the legal framework for the euro which are being made public by the Presidency. It invites the Council to adopt the first Regulation based on Article 235 of the EC Treaty without delay. The second Regulation will be adopted by the Council as early as possible in 1998, once the decision on the Member States participating in the euro area has been taken.

The Council, meeting in the composition of Heads of State or Government, has taken its decision under Article 109j(3) of the EC Treaty and confirms that the procedure laid down in Article 109j(4) will be applied

as early as possible in 1998, with a view to the commencement of the third stage of EMU on 1 January 1999. In this context, the European Council welcomes the intentions of the Member States to further reduce budgetary imbalances in 1997 with a view to achieving the high degree of sustainable convergence required for participation in the single currency and it underlines the need for durable convergence in the third stage.

The European Council underlines the importance of exchange rate stability for the process of convergence and the smooth operation of the internal market and accordingly warmly welcomes the entry into the ERM of the Finnish markka on 12 October 1996 and the re-entry of the Italian lira on 24 November 1996.

The European Council underscores the need to make the euro tangible for citizens. In this regard, it welcomes the designs for the euro bank notes presented by the European Monetary Institute. It also welcomes the arrangements being made by the Commission for the design competition for the coins; this will allow the choice to be made during the Dutch Presidency.

The Heads of State or Government decided to reappoint Baron Alexandre LAMFALUSSY as President of the European Monetary Institute as of 1 January 1997 until 30 June 1997. They decided to appoint Dr. Willem Frederik DUISENBERG, President of De Nederlandsche Bank, as President of the European Monetary Institute as of 1 July 1997 until the establishment of the European Central Bank.

2. SEM 2000 (Sound and efficient management)

The European Council endorsed the Council conclusions of 2 December 1996 on the report of the Personal Representatives Group on Sound Financial Management.

It reaffirmed its support for the Commission's SEM 2000 initiative and generally welcomed the recommendations in the report which constitute a substantial action programme to improve the financial management of EU expenditure in partnership between the Commission and the Member States.

The European Council invited Council and Commission to report on progress in implementing the recommendations to its meeting in December 1997.

[…]

Annex I: Report by the ECOFIN Council to the European Council

The preparations for stage 3 of EMU

Introduction

1. The European Council in Madrid a year ago confirmed that 1 January 1999 will be the starting date for Stage 3 of Economic and Monetary Union (EMU) in accordance with the convergence criteria, timetable, protocols and procedures laid out in the Treaty. Accordingly, the European Council requested the Council:

- to study, together with, in their respective fields of competence, the Commission and the European Monetary Institute (EMI), the range of issues raised by the fact that some countries may not initially participate in the euro area; in particular, the study should cover those issues related to monetary instability;

- to work on ways to ensure that, after moving to Stage 3, public finances are kept on a sound track in line with Treaty obligations. The European Council stated that budgetary discipline is of crucial significance both for the success of Economic and Monetary Union and for the acceptance of the single currency by the public; it noted the Commission's intention to present in 1996 its conclusions on ways to ensure budgetary discipline.

It requested the Council to report on these issues as soon as possible.

Furthermore, the Madrid European Council requested the Council to complete, at the latest by the end of 1996, the technical preparation of a Council Regulation on the legal framework for the use of the euro.

2. The Council has worked accordingly on all three issues and expects to be ready to decide on them at the same time. It has received substantial assistance from the Commission and the EMI in their respective fields of competence. The Council submitted a progress report to the European Council in Florence which urged the Council to pursue its work with a view to presenting conclusions showing further substantive progress to the European Council in Dublin. The informal meeting of Ministers and Governors in Dublin in September made further progress on these issues. On 16 October, the Commission adopted proposals for legislation on the legal framework for the euro and on budgetary discipline in Stage 3. The European Monetary Institute has prepared a report on monetary and exchange rate relationships in Stage 3 which the Council commends and attaches to this report.

3. An exchange rate mechanism would provide Member States having a derogation with a reference for their conduct of sound economic policies in general and monetary policy in particular. The Council therefore presents proposals for a new exchange rate mechanism (ERM 2) in Stage 3 of EMU. The details are described in Chapter I of this report and in the EMI report.

4. The Council sees a strong link between the exchange-rate issues and budgetary discipline and therefore considered both issues in parallel. Monetary policy cannot, without adequate support from fiscal and other policies, achieve its objective of price stability and secure that lasting convergence which fosters stable exchange rates. It needs adequate and sustained support from fiscal and other policies. A Stability and Growth Pact to ensure strict budgetary discipline on an enduring basis is therefore essential.

The Council, in its progress report to the European Council in Florence, has already submitted the outline of such a pact. Since that meeting, the Council has continued to work on this issue, and is now in a position to submit its suggestions for the main elements of a Stability and Growth Pact, including a possible European Council Resolution, in accordance with the procedures and principles of the Treaty. They are contained in Chapter II of this report.

5. In its work on the legal framework of the euro, the Council has been particularly reliant on assistance from the EMI and the Commission. The technical preparation for legislation was significantly advanced at the informal meeting of the Council in September. Chapter III reports on the state of preparation for legislation.

I. Relationships between Member States in the euro area and those outside in Stage 3

6. In its work on the relationship between the Member States forming part of and those not forming part of the euro area, the Council was guided by principles laid out in its progress report which was adopted by the Florence European Council. There it was agreed:

- that all Member States, whether adopting the euro or not, have a strong common interest in the good functioning of economic and monetary union and of the exchange rate mechanism. As a consequence, all Member States will be involved in the dialogue on the issues raised by the move to Stage 3 of EMU, including monetary and exchange-rate matters as well as institutional and budgetary issues;

- that a stable economic environment is necessary for the good functioning of the single market and for higher investment, growth and employment and is therefore in the interest of all Member States.

7. Over recent months, the Council has continued to work on these aspects of relationships between Member States forming part and those not forming part of the euro area. In so doing, it has sought to build on and to strengthen the unity which the Community has achieved and in particular to ensure that the relevant Community bodies continue to work effectively and harmoniously.

8. In the Council's progress report to the European Council in Florence, it was stated that the proper

functioning of the single market must not be endangered by real exchange-rate misalignments, or by excessive nominal exchange-rate fluctuations, between the euro and the other EU currencies, which would disrupt trade flows between Member States. Lasting convergence of economic fundamentals is a prerequisite for sustainable exchange-rate stability. To this end, there is agreement that in Stage 3 of EMU all Member States must pursue disciplined and responsible monetary policies directed towards price stability. The co-ordination of monetary policies in the framework of the ECB General Council will therefore play a central role. Sound fiscal and structural policies in all Member States are, at least, equally essential for sustainable exchange-rate stability.

9. The report adopted in Florence also made it clear that an exchange-rate mechanism can help to ensure that Member States orient their policies to stability foster convergence among the Member States not participating in the single currency, and thereby help them in their efforts to adopt the single currency. At the same time, it could also protect them and participating Member States from unwarranted pressures in the foreign-exchange markets. In such cases, it may assist non-participating Member States, when their currencies come under pressure, to combine appropriate policy responses, including interest rate measures, with co-ordinated intervention. And it would help to ensure that Member States seeking to adopt the euro after 1 January 1999 receive a treatment equal to that of those initially participating with respect to the fulfilment of the convergence criteria.

10. In view of these considerations, the European Council accepted that it is indeed appropriate that a new exchange-rate mechanism should replace the present ERM as from 1 January 1999. It would reflect lessons and experience gained with the present system and provide continuity. Sufficient flexibility would need to be allowed, in particular to accommodate the varying degrees, paces and strategies of economic convergence of the non-euro area Member States joining the mechanism ("the other participants"). Membership would continue to be voluntary. Nevertheless, Member States with a derogation can be expected to join the mechanism.

The new exchange-rate mechanism (ERM 2)

11. ERM 2 will be based on central rates, defined vis-a-vis the euro which will be at the centre of the system. The standard fluctuation band will be relatively wide, like the present one. Through the implementation of stability-oriented economic and monetary policies, the central rates will remain the focus for the participating Member States. Central rates and the standard fluctuation band will be set by mutual agreement between the Ministers of the euro-area Member States, the ECB and the Ministers and Governors of the central banks of the non-euro area Member States participating in the new mechanism, following a common procedure involving the European Commission, and after consultation of the Economic and Financial Committee. The Ministers and Governors of the central banks of the Member States not participating in the exchange-rate mechanism would not have the right to vote in the procedure.

12. Intervention at the margins will in principle be automatic and unlimited, with very short-term financing available. However, the ECB and the central banks of the other participants could suspend intervention if this were to conflict with the primary objective of maintaining price stability. It should be ensured that any adjustment of central rates is conducted in a timely fashion so as to avoid significant misalignments. All parties to the agreement, including the ECB, would have the right to initiate a confidential procedure aimed at reconsidering central rates.

13. The exchange-rate policy cooperation between the ECB and the central banks of the other participants could be further strengthened, for example by allowing closer exchange-rate links between the euro and the other currencies in ERM 2, where, and to the extent that, these are appropriate in the light of progress towards convergence. The procedure to be followed would depend on the form of the closer link. The initiative to agreeing to such links would lie with the non-euro area Member State concerned. The existence of such closer links, in particular if it implied narrower fluctuation bands, would be without prejudice to the interpretation of the exchange-rate criterion pursuant to Treaty Article (EC) 109j.

14. ERM 2, just as ERM 1, will require co-ordination of economic and monetary policies. The Treaty provides a good basis for the dialogue on assuring stability.

- As regards Member States' economic policies, Treaty Article (EC) 103 defines the framework for co-ordination at Community level. It provides for the discussion and adoption by the Council of broad guidelines of economic policies, and it sets out arrangements for multilateral surveillance of economic developments and policies in order to ensure closer co-ordination of economic policies and sustained convergence of economic performance. Moreover, if and as long as there are Member States outside the euro area, the Economic and Financial Committee will have the task of assisting the ministers in their monitoring of the operation of ERM 2 as well as keeping under review the monetary and financial situation of these Member States and reporting regularly thereon to the Council and the Commission.

- At the level of the central banks, the ECB General Council will monitor the functioning of the exchange-rate mechanism and will serve as a forum for monetary and exchange-rate policy co-ordination as well as for the administration of the intervention and financing mechanism.

While close co-operation between the Community bodies in the conduct of these various exercises will be necessary and useful, the division of responsibilities will need to respect the independence of the ECB and the non-euro area NCBs.

15. The main operational features of the new exchange-rate mechanism are described in the EMI paper annexed to this report.

A framework for stability

16. All Member States have mutual interests and obligations in the monetary field. Indeed, the Treaty states that each Member State shall treat its exchange-rate policy as a matter of common interest. As was reconfirmed in the Council's report to the European Council in Florence cited above, lasting convergence of economic fundamentals is a prerequisite for sustainable exchange-rate stability.

17. For all Member States, the surveillance procedures as described in paragraph 14 will seek to ensure that their domestic policies are geared to price stability and sound public finances, thus creating the conditions for keeping exchange rates stable. While membership of ERM 2 remains voluntary, Member States with a derogation can be expected to join the mechanism and thus to have a central rate vis-à-vis the euro, thereby providing a reference point which assists in judging the adequacy of their policies. Member States outside ERM 2 and thus not having a central rate will present policies, so as to enable appropriate surveillance in the Council, which can make, when necessary, non binding recommendations under Article 103, and in the General Council of the ECB. This surveillance will seek to ensure that their policies are oriented to stability and thus to avoid real exchange rate misalignments and excessive nominal exchange rate fluctuations. In this way, the provision of Treaty Article (EC) 109m, whereby each Member State shall treat its exchange rate policy as a matter of common interest, can be given effect. The policies will be presented in the convergence programmes.

The Council and the Commission are considering further the methods for the effective surveillance of exchange rate developments.

II. Ensuring budgetary discipline in Stage 3 of EMU (Stability and Growth Pact)

18. The Treaty imposes on Member States in Stage 3 of EMU an obligation to avoid excessive deficits. Sound government finances are crucial to preserving stable economic conditions in the Member States and in the Community. They lessen the burden on monetary policy and contribute to low and stable inflationary expectations such that interest rates can be expected to be low. They are an essential condition for sustainable and non-inflationary growth and a high level of employment.

19. To that end, the Council proposes to adopt regulations on the strengthening of surveillance and budgetary discipline and on speeding up and clarifying the excessive-deficit procedure. These regulations, combined with a European Council Resolution, will constitute a Stability and Growth Pact. The Resolution would enshrine the solemn political commitment of the Commission, the Council and the Member States to the strict and timely application of the pact. The surveillance procedure and the excessive-deficit procedure (except, in particular, sanctions) will be common to all Member States. Euro area Member States will be obliged to submit stability programmes and will be subject to agreed sanctions for failure to act effectively on excessive deficits. In the surveillance procedure, the other Member States will be obliged to submit convergence programmes only. In the excessive-deficit procedure, sanctions cannot be applied to them.

20. In this chapter of the report, the Council submits the main elements of the Stability and Growth Pact. A credible and effective pact will ensure budgetary discipline in Stage 3 of EMU in accordance with the principles and procedures of the Treaty, while in no way changing the requirements for the adoption of the euro, either in the first group or at a later date.

Reinforced surveillance of budgetary positions

21. Each Member State will commit itself to aim for a medium-term budgetary position of close to balance or in surplus. This will allow the automatic stabilizers to work, where appropriate, over the whole business cycle without breaching the 3 per cent reference value for the deficit. This was agreed by the European Council in Florence.

22. Member States adopting the euro will be required by secondary legislation to present stability programmes, which will specify their medium-term budgetary objectives, together with an adjustment path for the government surplus or deficit ratio and the expected path for the government debt ratio. Furthermore, the programmes will contain the main assumptions about economic developments as well as a sensitivity analysis of the deficit and debt position and explain what is being done to achieve the objective.

23. A separate legislative proposal will be forthcoming from the Commission which will provide for the submission of convergence programmes by the non-euro area Member States. The information they will contain, as far as budgetary policy is concerned, will be similar to that of the stability programmes.

24. Member States will commit themselves to take the action they think necessary to achieve the objectives of their programmes. Stability and convergence programmes will be multiannual and will be updated annually to take account of the latest available information. Member States will make their stability and convergence programmes public.

Early warning system: monitoring and surveillance

25. The Commission and the Council will study these stability and convergence programmes and monitor Member States' budgetary performances with reference to their medium-term objectives and adjustment paths with a view to giving early warning of any significant deterioration which might lead to an excessive deficit. In such cases, the Council will address recommendations to the Member State concerned.

Excessive deficit procedure

26. Adherence to the objective of sound budgetary positions close to balance or in surplus will allow a Member State to deal with normal cyclical fluctuations while keeping its government deficit within the 3 percent reference value. Nevertheless, to deter excessive deficits and to ensure that, should they occur, they are promptly eliminated, there is a need for detailed provisions for the implementation of the excessive-deficit procedure. A Council Regulation will provide for expediting and clarifying the procedure, in particular by establishing clear definitions and setting deadlines for the various steps. Once it has decided

that an excessive deficit persists, and as long as a Member State has failed to comply with a decision under Treaty Article (EC) 104c(9), the Council will, in accordance with paragraph 11 of that Article, impose sanctions on a prescribed scale. The European Council Resolution described in paragraph 37 will provide political guidance on how this procedure can be operated efficiently and speedily.

27. An excess of a government deficit over the 3 per cent reference value shall be considered exceptional when resulting from an unusual event outside the control of the relevant Member State and which has a major impact on the financial position of general government, or when resulting from a severe economic downturn.

28. The Commission will be invited to commit itself in the European Council Resolution (see paragraph 37) to prepare a report whenever the actual or planned government deficit exceeds the 3 per cent reference value, thereby triggering the procedure under Article 104c(3). The Commission, when preparing such a report, will consider, as a rule, an excess over the reference value resulting from an economic downturn to be exceptional only if there is an annual fall of real GDP of at least 2%.

29. The Economic and Financial Committee will formulate an opinion on the Commission report within two weeks. The Commission, taking fully into account this opinion and if it considers that an excessive deficit exists, will address an opinion and a recommendation to the Council for a decision. In the event that the Commission considers that a deficit is not excessive, the Commission will be invited to commit itself in the European Council Resolution to present in writing to the Council the reasons for its position. This would give the Council the opportunity to discuss the issue taking account of both the Commission's position and the opinion of the Economic and Financial Committee. The Council could decide, by simple majority, to request the Commission under Article 109d to make a recommendation. The Commission will be invited to commit itself in the European Council Resolution to issue, as a rule, such a recommendation, in response to the Council request.

30. The Council when deciding, according to Article 104c (6) on a Commission recommendation, whether an excessive deficit exists, will in its overall assessment take into account any observations made by the Member State showing that an annual fall of real GDP of less than 2% is nevertheless exceptional in the light of further supporting evidence, in particular on the abruptness of the downturn or on the accumulated loss of output relative to past trends.

31. Where it decides that an excessive deficit exists, the Council will, at the same time, make recommendations to the Member State concerned "with a view to bringing that situation to an end within a given period" (Article 104c (7)). These recommendations will accordingly set clear deadlines for i) the taking of effective action (within four months), and ii) the correction of the excessive deficit, which should be completed in the year following its identification unless special circumstances are given. The Council's initial judgement on whether effective action has been taken will be based on publicly-announced decisions of the Government.

32. If a Member State fails to act in compliance with the successive decisions of the Council under paragraphs 7 to 9 of Article 104c, the Council will, in accordance with paragraph 11 of that Article, impose sanctions including a non-interest bearing deposit. These sanctions would be imposed within ten months of the reporting of the figures notifying the existence of an excessive deficit. An expedited procedure will be used in the case of a deliberately planned deficit which the Council decides is excessive.

33. The excessive deficit procedure will be held in abeyance if a Member State does in fact adopt, through formal government decision, appropriate action in response to a recommendation under Article 104c (7) or a notice issued under Article 104c (9). The Commission and Council will monitor the progress of the Member State continuously until the Council decides under Article 104c (12) that the excessive deficit has been corrected. If the action is not being implemented, or is proving to be inadequate, the procedure will resume immediately. This would lead to sanctions being imposed in accordance with Article 104c (11) within three months of the procedure's resumption.

34. If actual data demonstrate that an excessive deficit has not been corrected within the time limit specified either in the Recommendation under Article 104c (7) or the notice issued under Article 104c (9), the Council will immediately resume the excessive deficit procedure.

Structure and scale of sanctions

35. Whenever sanctions are first imposed, a non-interest-bearing deposit should be included. This should be converted into a fine after two years if the deficit of the government concerned continues to be excessive. When the excessive deficit results from non-compliance with the government deficit reference value, the amount of the deposit or fine will be made up of a fixed component equal to 0.2% of GDP, and a variable component equal to one tenth of the excess of the deficit over the reference value of 3% of GDP. There will be an upper limit of 0.5% of GDP for the annual amount of deposits. The amount of the sanction will be based on outcomes for the year in which the excessive deficit occurred.

36. Further consideration is being given to the disposition of the interest on deposits and the proceeds of fines on the proviso that there would be no increase in Community spending.

European Council Resolution on the Stability and Growth Pact

37. When using the leeway which secondary legislation necessarily must leave to them, the Council and the Commission may receive guidance from the European Council, through, for example, a European Council Resolution. Such a Resolution would give strong political guidance to the Commission, the Council and the Member States on the implementation of the procedures. The Resolution would invite all parties to implement the Treaty and the Stability and Growth Pact regulations strictly. The Commission should express a clear commitment to that effect, which would include an undertaking to prepare a report on the budgetary situation in a country whenever there is the risk of an excessive deficit or the planned or actual government deficit exceeds the reference value.

The Council would be invited to take the decisions necessary for carrying the procedure forward as quickly as practicable. If the Council did not act on a Commission recommendation at any stage in the procedure, the Resolution would invite the Council always to state in writing the reasons which justify its decision not to act and to make public the votes cast by each Member State. The Resolution would also cover political agreements on the implementation of the Stability and Growth Pact. In particular, the Resolution would invite the Council always to decide to impose sanctions if a participating Member State fails to take the necessary steps to bring the excessive deficit situation to an end as recommended by the Council.

The Resolution will contain an undertaking by the Member States not to invoke the benefit of the provision in paragraph 30 unless they are in severe recession. In evaluating whether the economic downturn is severe, the Member States will as a rule take as a reference-point an annual fall in real GDP of at least 0.75%.

The recitals of the Council Regulation would make an explicit reference to the Resolution.

III. Legislation establishing the legal framework for the use of the euro

38. The legal framework for the use of the euro is of the greatest importance, encompassing as it does the lex monetae of the monetary union and the legal provisions by which the single currency replaces the participating national currencies and the European Currency Unit (ECU).

It was agreed at the informal meeting in Dublin that it was imperative in the interests of the smooth functioning of the financial markets that certain matters be clarified on a firm legal basis as soon as possible.

39. It was accordingly decided to separate the provisions which must be enacted soon and to envisage their early adoption in a Council Regulation under Treaty Article (EC) 235. This Regulation will cover,

principally, the replacement of the ECU by the euro at a rate of one to one at the start of the third stage, the continuity of contracts when the euro is introduced and technical rules for the conversion rates, including rounding. All other provisions will be included in a Council Regulation to be adopted under Treaty Article (EC) 109l (4). Although this Regulation cannot be adopted by the Council until early 1998, earlier stages in the legislative process are being completed.

This Regulation will provide, in particular, that the currency of the participating Member States shall be the euro from the first day of the third stage and that during a transitional period the euro shall be divided into national currency units; it will also regulate the introduction of euro notes and coins. Following the principle of "no prohibition, no compulsion", this legislation will at the same time regulate the use of the euro and the national currency units during the transitional period and will ensure that the monetary law of participating Member States will continue to apply, subject to the provisions of the Regulation, during that period, while national notes and coins will continue to be the sole legal tender.

40. On 16 October 1996, the Commission adopted proposals for these two Regulations. Since then these proposals have been examined intensively in a Council Working Group. There is now a text for the Regulation under Article 235 as agreed within the Council Working Group. The Group also agreed the text of the other Regulation. The provisions in articles 10 and 11 of the Regulation based on Treaty Article 109 l (4), on the circulation of euro notes and coins, provide for a date to be decided, in accordance with the Madrid scenario when the regulation is adopted: for technical reasons, it is not possible to decide this date now. Further work also remains to be done on Article 8(4).

The Council, having taken into account the opinions of the European Parliament and the EMI, endorsed the text of both Regulations on 12 December 1996.

IV. Conclusion

41. The European Council is invited to approve this report. Subject to that approval, the Council proposes the following actions:

a. The new exchange rate mechanism

The Council will present a draft Resolution for adoption by the European Council in June of next year, setting out the fundamental elements of ERM2. In this Resolution, the European Council would be following the precedent set in 1978 in relation to the present mechanism. In parallel, the EMI would prepare a draft for an inter-central bank agreement, for submission to the European Central Bank (ECB) and the central banks of the Member States not forming part of the euro area when the ECB comes into existence.

b. The Stability and Growth Pact

After the Dublin European Council meeting, the Council will establish a working group which will examine intensively the Commission proposals with a view to adoption of these Regulations immediately after the European Council, in June of next year, has adopted a Resolution on the Stability and Growth Pact, a draft of which will be presented by the Council.

c. The legal framework for the use of the euro

The urgent Regulation under Article 235 will be adopted by the Council at an early date. Formal adoption of the Regulation based on Article 109 L (4) is not possible until 1998. Together, the two regulations establish the legal framework for the use of the euro.

Annex 1 to ANNEX I
Decisions to be taken under Treaty Article (EC) 109j (3) by the Council meeting in the composition of Heads of State or Government

As part of the preparations for Stage 3 of EMU and according to Article 109j (2), the Council has to assess at the end of 1996 for each Member State, whether it fulfils the necessary conditions for the adoption of a single currency, and whether a majority of the Member States fulfil the necessary conditions, and to recommend its findings to the Council, meeting in the composition of the Heads of State or Government. It was already clear to the European Council in Madrid a year ago, and confirmed in Florence, that at the end of 1996 there would be no majority of Member States fulfilling the conditions for the adoption of a single currency and that, therefore, 1 January 1999 (the latest date envisaged in the Treaty) would be the start date of Stage 3 of EMU.

As the basis for its Recommendation, the Council has received reports in accordance with paragraph 1 of Article 109j from the Commission and the EMI. These reports examine, as the Treaty requests, the compatibility of each Member State's national legislation, including the statutes of its national central bank, with Articles 107 and 108 of the Treaty and the Statute of the European System of Central Banks (ESCB). The reports also examine the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of four criteria. These criteria relate to price stability, the sustainability of the government financial position, the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System and long-term interest-rate levels.

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, when the criteria are applied in early 1998, they are applied with a view to ensuring that government financial positions in particular are sustainable and not affected by measures of temporary effect.

The reports under Article 109j (1) indicate that many steps have been taken towards ensuring the independence of the national central banks but that in some Member States the process is not yet complete. Similarly, with regard to convergence, progress has been achieved but much remains to be done. In particular, government financial positions remain unsatisfactory in many countries: some improvements have been achieved in recent years but substantial efforts still have to be undertaken to reduce government deficits and debt.

The (Ecofin) Council has therefore made an assessment under paragraph 2 of that Article, on a recommendation from the Commission, that at present there is not a majority of the Member States fulfilling the necessary conditions for the adoption of a single currency and presents to the Council meeting in the composition of the Heads of State or Government a Recommendation for a decision to that effect and a decision that the Community will therefore not enter the third stage of EMU in 1997 and that thus the procedure laid down in Article 109j (4) will be applied as early as possible in 1998.

The Council, meeting in the composition of the Heads of State or Government will also wish to take into account the Opinion of the European Parliament.

Annex 2 to ANNEX I
European Monetary Institute (7 October 1996)
Final monetary and exchange rate policy cooperation between the euro area and other EU countries

Report to the European Council session in Dublin on 13-14 December 1996

Introduction

In accordance with the mandate given by the European Council meeting in Madrid and building on the agreement reached at the European Council session in Florence as well as on the broad support expressed at the Informal ECOFIN Council session in Dublin, the EMI has finalized the first stage of its preparatory work on the future monetary and exchange rate relationships between the euro area and other EU countries.

The report reflects the high level of consensus reached in the EMI Council on the objectives, principles and main operational features of the new exchange rate mechanism.

I. Objectives, principles and overall structure

1. The need for monetary and exchange rate policy cooperation

Close policy coordination between the euro area and the other Member States from the very start of Stage Three of EMU is a matter of common interest and forms an integral part of the completion of the EMU process. In order to ensure the efficient functioning and development of the Single Market, it is especially important that real exchange rate misalignments between the euro and the other EU currencies be avoided, as well as excessive nominal exchange rate fluctuations, which would disrupt trade flows between Member States; hence the obligation under Article 109m to treat exchange rate policy as a matter of common interest.

The lasting convergence of economic fundamentals, in particular price stability, is a prerequisite for sustainable exchange rate stability. To this end, in Stage Three of EMU, all Member States will need to pursue disciplined and responsible monetary policies directed towards price stability. The coordination of monetary policies within the framework of the ECB General Council will, therefore, play a central role. Sound fiscal and structural policies in all Member States are, at least, equally essential for sustainable exchange rate stability. In the absence of a convergence of fundamentals, any attempt to coordinate exchange rate policies is bound to be unsuccessful. Exchange rate policy cooperation cannot be a substitute for stability-oriented domestic policies.

The final objective of economic, monetary and exchange rate policy cooperation is convergence towards macroeconomic stability, which would lead to exchange rate stability against the euro. A nominal exchange rate mechanism may provide a reference for the conduct of sound economic policies in Member States on their way towards full economic convergence. It may help to enhance the credibility of such policies by establishing a focal point for agents' expectations. Moreover, it may provide a framework for counteracting market pressures unwarranted in the light of underlying fundamentals. In particular, it may assist any Member State, the currency of which comes under pressure, to combine appropriate policy responses, including interest rate measures in the country the currency of which is under pressure, with coordinated intervention.

Monetary and exchange rate policy cooperation should be flexible enough to accommodate different degrees and strategies of economic convergence. As noted in the Conclusions of the European Council meeting in Florence, "Membership would continue to be voluntary; nevertheless, Member States with a derogation can be expected to join the mechanism", once they have achieved a satisfactory degree of economic convergence. In addition, the various Community mechanisms for the coordination of economic and monetary policies (see also Chapter II, Section 2) should ensure that exchange rate developments in all other Member States, irrespective of their participation in the exchange rate mechanism, are closely monitored and assessed with a view to the requirements of Article 109m of the Treaty and the smooth operation of the Single Market. While the remainder of this report focuses on the exchange rate mechanism, the necessary broader scope of the overall policy coordination framework should be borne in mind.

2. Principles for an exchange rate mechanism in Stage Three

In designing an exchange rate mechanism for Stage Three, the new economic and institutional environment which is expected to prevail by that time will have to be taken carefully into account. In particular, five elements must be underlined.

First, the statutory requirement for the ECB to maintain price stability would need to be safeguarded. It would be detrimental to the credibility of EMU if obstacles were to emerge as a consequence of exchange rate oriented measures which would hinder the newly-created ECB in the pursuit of its primary objective. These considerations would also apply to the non-euro area NCBs, which should also pursue the primary

objective of price stability. Second, the euro is expected to play the anchor role in monetary and exchange rate policy cooperation in the EU. This will be the natural consequence, first and foremost, of the stability of the euro and the fact that member countries with a derogation are expected to put in place the conditions to enable them to participate in the euro area at a later stage.

Third, sufficient flexibility would need to be allowed, in particular to accommodate the varying degrees, paces and strategies of economic convergence of the non-euro area Member States.

Fourth, it should be ensured that any adjustment of central rates is conducted in a timely fashion so as to avoid significant misalignments.

Finally, as a matter of principle, continuity and equal treatment among all Member States with respect to the fulfilment of the convergence criteria, including the exchange rate criterion, need to be ensured.

3. Overall structure of the mechanism

Given the respective competences and responsibilities, it would be appropriate to retain the two-pillar structure of the present ERM, which is based on two parallel agreements among governments, on the one hand, and among central banks, on the other: while a European Council Resolution would form the foundation of the new mechanism, the operating procedures would be laid down in an agreement between the ECB and the non-euro area NCBs.

II. Main operational features of an exchange rate mechanism

In the light of the abovementioned principles, the new mechanism could be designed along the following lines.

1. Central rates and fluctuation bands

The new exchange rate mechanism would be based on central rates, defined vis-à-vis the euro for the non-euro area currencies. A standard fluctuation band would be established for these currencies around their central rates. Although the exact size of the standard fluctuation band has yet to be decided, it is expected to be relatively wide.

If appropriate, non-euro area Member States could establish, on a bilateral basis, fluctuation bands between their currencies and intervention arrangements, with the aim of limiting excessive bilateral exchange rate oscillations. Prior to concluding such arrangements, the non-euro area Member States concerned would consult, on a strictly confidential basis, all the other parties to the new exchange rate mechanism.

Central rates and the standard wide band would be set by mutual agreement between the ECB, the Ministers of the euro area Member States, and the Ministers and Governors of the central banks of the non-euro area Member States, following a common procedure involving the European Commission and after consultation of the Economic and Financial Committee. The Ministers and Governors of the central banks of the other Member States not participating in the exchange rate mechanism will not have the right to vote in the procedure.

The sustainability of exchange rate relations will need to be closely monitored on a permanent basis. All parties to the agreement, including the ECB, would have the right to initiate a confidential procedure aimed at reconsidering central rates.

2. Monitoring the functioning of the system

Intra-EU monetary and exchange rate policy coordination between the euro area and the non-euro area Member States will, pursuant to the Treaty, be conceived as a continuation of the present mechanism. The

Economic and Financial Committee will, together with the European Commission, be involved in economic policy coordination. Furthermore, if and as long as there are Member States with a derogation, the Economic and Financial Committee will keep under review the monetary and financial situation of these Member States. At the level of the central banks, the ECB General Council will monitor the functioning of the exchange rate mechanism and will serve as a forum for monetary and exchange rate policy coordination as well as for the administration of the intervention and financing mechanism. While close cooperation between the Community bodies in the conduct of these various exercises will be necessary and useful, the division of responsibilities will need to respect the independence of the ECB and the non-euro area NCBs.

3. Intervention and financing facilities

Foreign exchange intervention and - after appropriate use of foreign reserve holdings - financing at the standard wide margins will, in principle, be automatic and unlimited. Intervention should be used as a supportive instrument in conjunction with other policy measures, including appropriate fiscal and monetary policies conducive to economic convergence.

The ECB and the non-euro area NCBs would have the possibility of suspending intervention and financing if these were to impinge on their primary objective. In deciding whether or not to resort to this safeguard clause, the ECB or a non-euro area NCB would take due account of all relevant factors, in particular the need to maintain price stability and the credible functioning of the new exchange rate mechanism. Without prejudice to its independent assessment, in line with Articles 105 and 107 of the Treaty, as to whether there is a risk to its primary objective, the ECB would base its decision on factual evidence and, in this context, also give consideration to any conclusion which may have been reached by other competent bodies. It would appear neither advisable nor possible to define formally and ex ante the circumstances under which the possibility of suspending intervention might be used. The final decision would rest with the ECB or the non-euro area NCB concerned, but it would be understood that, time permitting, the ECB or the NCB concerned would signal as far ahead of time as possible its intention of suspending intervention and financing.

The possibility of coordinated intramarginal intervention decided by mutual agreement between the ECB, as the central bank issuing the intervention currency, and the respective NCB, in parallel with other appropriate policy responses by the latter, would be retained. As in the present ERM, unilateral intramarginal intervention would continue to be subject to prior approval by the central bank issuing the intervention currency concerned, should it exceed certain thresholds.

The present Very Short-Term Financing facility (VSTF) would be continued, following some appropriate adjustments. The initial duration (2 1/2 to 3 1/2 months), as well as the rules for extending maturities of VSTF financing operations (renewable twice for three months subject to certain ceilings and/or the agreement of the creditor central bank) would be retained. Outstanding balances would, as in the present ERM, be remunerated at a representative market interest rate corresponding to the duration and currency denomination of the credit. Financing balances would be denominated in the creditor's currency. VSTF balances would be settled in the creditor's currency, unless otherwise agreed between the creditor and debtor central banks.

The present ERM rules governing access to the VSTF facility for intramarginal intervention would be broadly continued, including the understanding that appropriate use of foreign reserve holdings would be made prior to resorting to the VSTF facility. The size of the ceilings for such access could, initially, be retained and adjusted in the light of experience of the practical operation of the mechanism.

The Short-Term Monetary Support Mechanism (STMS) should be discontinued, given its very limited practical relevance in the past. To the extent that the STMS quotas are relevant for the definition of VSTF ceilings, the latter may have to be redefined.

4. Closer exchange rate cooperation

The exchange rate policy cooperation between non-euro area NCBs and the ECB could be further

strengthened. This might take various forms: inter alia, closer links may entail narrower fluctuation bands, which would be made public, with automatic intervention and financing at the narrow limits; alternatively, they may rely on informal narrower target ranges, which might be kept confidential, supported through an enhanced role for coordinated intramarginal intervention. However, a proliferation of ad hoc links should be avoided. To this effect, a standard arrangement could be used as a reference for closer links with NCBs of non-euro area Member States which have achieved a sufficiently high degree of convergence. The existence of such closer cooperation, in particular if it implied narrower fluctuation bands, would be without prejudice to the interpretation of the exchange rate criterion pursuant to Article 109j of the Treaty.

Closer exchange rate links would be agreed upon on a case-by-case basis at the initiative of the interested non-euro area Member State. The procedure to be followed would depend on the form of the closer link. Arrangements implying publicly announced narrower fluctuation bands would be agreed upon by the ECB, the Ministers of the euro area Member States and the Minister and Governor of the central bank of the non-euro area Member State concerned, after consultation of the Ministers of the other non-euro area Member States and the ECB General Council. All other closer arrangements of a more informal nature would be agreed upon by the ECB and the central bank of the non-euro area Member State concerned, after consultation of the Ministers of all Member States and the ECB General Council.

Closer exchange rate links would be subject to progress in economic convergence, although they should not be seen as the only possible strategy to be followed by non-euro area Member States on their way towards full economic convergence. They would require a continuous monitoring of the sustainability of the closer exchange rate link and an active use of accompanying policy measures by the non-euro area Member State. All parties having agreed upon a closer exchange rate arrangement, including the ECB, would have the right to trigger a confidential re-examination of the adequacy of such a closer exchange rate link and, if applicable, to suspend intervention and financing in the event of conflict with the primary objective of price stability.

Concluding remarks

The basic features of a mechanism to succeed the present ERM should be announced well ahead of the decision on the first wave of participants in the euro area. Thus, markets would be reassured about the continuity of monetary and exchange rate policy cooperation in the EU, preserving the role of the present ERM for non-euro area currencies during the interim period. This could help to allay any incipient market fears about the management of the exchange rates of non-euro area currencies after the start of Stage Three. Full specification of the operational details would have to await the establishment of the ECB.