



MONETARY POLICY AFTER MAASTRICHT

How much independence will Britain possess?

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Introduction

Recent discussion about the implications of the Maastricht Treaty on European Union has been far ranging and sometimes intense, but little attention has been paid to the nature and extent of the legal obligations assumed by the United Kingdom under the Treaty in relation to monetary union. As everyone knows the United Kingdom has negotiated an 'opt out' from the European single currency; as a result it is widely assumed that the monetary union obligations set out in the Treaty are not of great importance unless and until the UK takes a decision to 'opt in'. As I shall show, this is far from being the case.

Another concern of this paper relates to the debates as to whether or not sterling should return to the Exchange Rate Mechanism ('ERM') or should remain for the long term a floating currency; even where the objective of returning sterling to the ERM is accepted, there is debate as to when it would be appropriate to do so and upon what terms, particularly in relation to the reforms to the ERM, which the British government favours in the light of its recent bitter experience.

Much of this debate assumes that these decisions about the ERM are and will remain matters of policy choice for the United Kingdom, with the decisions to be made at a moment of our own choosing. It is widely assumed that, thanks to the opt-out clauses, the Maastricht Treaty will not foreclose the policy choice which the United Kingdom may wish to exercise.

The 'opt-out' clauses relate only to the third or final stage of monetary union; less well recognised is the fact that the Treaty contains obligations as regards the conduct of UK exchange rate and monetary policy during Stage 3 even if the pound then remains outside the new single currency block. Accordingly, the fundamental objective of this paper is to examine the extent of the freedom of action which the United Kingdom will retain under the Treaty in respect of its own future exchange rate and monetary policy. In particular it seeks an answer to the following question: If the UK ratifies the Maastricht Treaty but decides to pursue the policy of floating exchange rates for an indefinite period, will Britain be judged to be in breach of its treaty obligations?

In seeking answers to this and to related questions I shall not, however, attempt to deal with the economic arguments about the desirability or undesirability of floating as against fixed exchange rates. I concentrate merely on exploring the legal implications of the Maastricht Treaty which may affect the UK's future scope for action in the realm of monetary and exchange rate policy.

The obligations of monetary union

The monetary union provisions in the Treaty of Maastricht are contained in the section of the Treaty which comprises amendments to the Treaty of Rome. This means that the monetary union provisions become part of European Community Law, enforceable through the normal mechanisms of the European Court of Justice and having force within the United Kingdom as part of this country's law; indeed, forming its supreme law¹.

Monetary Union is envisaged as taking place in three stages. Stage 1, which comes into force as soon as the Treaty of Maastricht is in place, envisages that member states will pursue policies designed to lead to economic convergence. Stage 2, due to take effect from 1 January 1994², requires member states to 'endeavour to avoid excessive budget deficits³', restricts lending by central banks to governments and public sector bodies⁴, and envisages that member states will seek to maintain their currencies in the narrow bands of the Exchange Rate Mechanism ('ERM') and will avoid devaluation⁵.

Stage 3 involves the establishment of a European Central Bank, the abolition of the currencies of those member states which proceed to Stage 3, and the replacement of those currencies with a single currency, the 'ECU'. The currencies involved will be those which satisfy four 'convergence criteria' set out in Article 109j(1):

- (1) Inflation rate at or close to that of the three lowest inflation member states.
- (2) Low government deficit.
- (3) Maintenance of exchange rate in ERM narrow bands for at least two years without devaluing.
- (4) Low long term interest rate levels.

Stage 3 monetary union commences once the European Council (summit meeting of heads of government) judges that a majority of member states have achieved the convergence criteria⁶. Stage 3 monetary union will in any case take effect from 1 January 1999, even if by then only a minority of member states have achieved the convergence criteria⁷.

At the commencement of Stage 3, the 'convergent' member states are required to abolish their currencies and to form a single currency ECU block. The non-convergent

member states, however, will retain their own currencies and under the Treaty will have a 'derogation'⁸ from full monetary union. It is envisaged that these latter member states will continue to strive to achieve the 'convergence criteria': as and when they do so, their derogations will be removed and they will join the ECU block⁹. In the meantime, they are excluded from voting rights in the operation of the European Central Bank and ECU monetary policy¹⁰.

Britain's 'opt-out' clause

The United Kingdom's 'opt-out' is embodied in a Protocol to the Treaty. Broadly speaking, its effect is to oblige the UK to take part in Stages 1 and 2 of monetary union. It need not, however take part in Stage 3 unless it opts to do so. Once Stage 3 is in force, the UK will be treated broadly as if it were a member state with a 'derogation'. If the UK meets the convergence criteria, it can opt into the ECU block after the start of Stage 3¹¹.

As indicated above, the Treaty *envisages* that all member states will be trying to achieve the convergence criteria. The Treaty envisages that some member states may fail in this attempt, so it follows that it cannot be an absolute Treaty requirement to succeed. However, the Treaty does envisage that member states will be *trying*. The key question is whether or not the Treaty imposes *an obligation to try*.

The most far reaching Treaty obligation regarding monetary union is that set out in new article 3a(2), which provides that the activities of the Community 'shall include the irrevocable fixing of exchange rates leading to the introduction of a single currency, the ECU, and the definition and conduct of a single monetary policy and exchange rate policy'. The UK opt-out applies to this paragraph¹².

The United Kingdom is not therefore bound by the Treaty objective of seeking the *irrevocable fixing* of its exchange rate, which will happen for other 'convergent' member states at the start of Stage 3. However, the United Kingdom is bound by Treaty obligations which apply to Stages 1 and 2, and to 'derogated' member states under Stage 3. Articles 102a and 103 on economic policy read as follows:—

'Member states shall conduct their economic policies with a view to contributing to the objectives of the Community, as defined in Article 2, and in the context of the broad guidelines referred to in Article 103(2). . . .'

'Member states shall regard their economic policies as a matter of common concern, and shall co-ordinate them within the Council, in accordance with the provisions of Article 102a.'

Subsequent paragraphs – numbers 103(2) and (3) – provide a procedure for the laying down of the guidelines by the Council of Ministers acting with qualified majority voting, and 'multilateral surveillance' by the Commission of member states' compliance with the guidelines.

As regards monetary policy, the United Kingdom is bound, in common with all other member states, by Article 109m:

'1. Until the beginning of the third stage, each member state shall treat its exchange rate policy as a matter of common interest. In so doing, member states shall take account of experience acquired in co-operation within the framework of the European Monetary System (EMS) and in developing the ECU, and shall respect existing powers in this field.

2. From the beginning of the third stage and for so long as a member state has a derogation, paragraph 1 shall apply by analogy to the exchange rate policy of that member state.'

The second of these paragraphs is expressly stated to apply to the United Kingdom, if opted out of Stage 3, as if the UK were a member state with a derogation¹³.

It is clear that these provisions do impose Treaty obligations on the United Kingdom as regards the conduct of its economic and monetary policy. In particular, Article 109m requires the United Kingdom to treat exchange rate policy as a matter of 'common interest' both during Stages 1 and 2, and after the start of stage 3 so long as the pound sterling remains a separate currency.

Obviously, this must impose some obligation over and above that of pursuing an exchange rate policy solely in the national interest, otherwise these paragraphs can have no purpose whatever. The wording is similar to that of existing Article 107(1) of the Treaty of Rome, although 'common concern' has been replaced with 'common interest' in the English text, possibly a somewhat stronger expression. However, of more importance than the change of wording is the profound change of the Treaty context, since the precise scope of such an obligation would be interpreted by the European Court, the Commission and others, as taking colour from the framework of other provisions set out in the Treaty.

National interest versus common interest

The concept of 'common interest' as regards exchange rate policy is not academic or unimportant. In his speech to the Conservative Party Conference on 8 October 1992, the Chancellor of the Exchequer urged the British car industry to take advantage of the depreciation of the exchange rate by exporting vigorously to Continental markets. The increased competitiveness of British industry resulting from sterling devaluation, however, will necessarily cause concern to Continental car manufacturers, and indeed to other industries as well.

By accepting that its exchange rate policy should be treated as a matter of 'common interest', in the context of a Treaty contemplating a structure of narrow band exchange rate parities, the United Kingdom is giving other member states and the Community institutions grounds for complaint. Specifically, such complaints are likely to be made should the United Kingdom pursue an exchange rate policy in its own national interest but which is judged to be at variance with the national interests of other member states. Such complaints could originate with the Commission or with member states.

Under Article 109e, the United Kingdom (in common with other member states) assumes an obligation before 1st January 1994 to:-

'adopt, if necessary, with a view to permitting the assessment provided for in subparagraph (b), multiannual programmes intended to ensure the lasting convergence necessary for the achievement of economic and monetary union, in particular with regard to price stability and sound public finances;

(b) the Council shall, on the basis of a report from the Commission, assess the progress made with regard to economic and monetary convergence, in particular with regard to price stability and sound public finances, and the progress made with the implementation of Community law concerning the internal market.'

By Article 109f(4) the European Monetary Institute (the Stage 2 precursor to the European Central Bank of Stage 3) may [my emphasis]:-

' - formulate opinions on the overall orientation of monetary policy *and exchange rate policy* as well as related measures *in each member state*

– submit opinions or recommendations *to Governments* and to the Council on policies which might affect the internal or external monetary situation in the Community and, in particular, *the functioning of the EMS*

– make recommendations to the monetary authorities of *member states* concerning the conduct of their monetary policy’

Although opinions and recommendations do not have binding legal force as such, this provision is indicative of the scope of the underlying Treaty obligation assumed by member states with regard to their exchange rate policies during Stage 2.

Let us suppose that the United Kingdom – once Maastricht is in force – decides that it is in the United Kingdom’s interest to continue floating the exchange rate for the time being or for an indefinite period. Let us also suppose that the Commission or other member states object to this policy (for the reasons set out above concerning competitive effects on Continental industries) and wish the UK to return to the ERM.

Scenarios of this kind require no leap of imagination: pressure of this kind is already being applied. On 22 October 1992, Mr Pedro Perez, Spain’s Secretary of State for Economic Affairs, expressed his hope that sterling would return to the ERM some time in 1993, adding: ‘You cannot have a genuine single market with two systems of currency parities, one of which is fixed for nine currencies and one which is floating for three currencies¹⁴.’ This type of pressure is likely to remain muted so long as Maastricht ratification is still in question. But once ratification has taken place, there is no doubt that other member states will forcibly express their views on sterling’s return to the ERM, and will use the avenues open to them under the Treaty to compel the UK to fulfill what they see as the UK’s obligations.

What can be expected so long as the UK remains outside the ERM is a pattern of steadily mounting pressure from other member states, followed by Commission representations that the UK’s stance does not live up to our Treaty obligations. This might be followed by legal challenges to the UK, possibly initially directed to the most readily attackable consequences of the UK’s policy, such as the fact that its ‘multiannual programme’ submitted under Article 109e(2) (a) did not contain proposals for ERM re-entry. By stages, the political and legal pressures would increase. During Stage 2, the European Monetary Institute would make recommendations to the UK regarding its exchange rate policy under Article 109f(4). A reference by the Commission to the European Court of Justice (‘ECJ’) would become likely or

inevitable if the UK were to remain obdurate in the indefinite pursuit of a floating exchange rate policy. Would the ECJ find that the UK's policy was compatible with the Treaty?

The conclusion must be that the ECJ would find that a policy of indefinitely remaining outside the ERM on the part of the UK is a clear breach of the Treaty. First, in such circumstances, the United Kingdom would be avowedly pursuing an exchange rate policy based on its own national interest rather than treating it as a matter of 'common interest' as required by Article 109m. Secondly, the UK would be failing to adopt a 'multiannual programme' intended to ensure 'economic and monetary convergence': moving towards and when possible adopting a fixed ERM parity is one element of 'convergence' since it forms one of the convergence criteria set out in Article 109j(1).

Thirdly, and most fundamentally, the whole structure of Stages 1 and 2 monetary union presupposes that member states are striving towards achievement of the convergence criteria, including more tightly aligned parities. Although the UK has opted out of the final objective of 'irrevocably fixed' parities in Article 3a(2), it has not opted out of the lesser objective of exchange rate convergence. It is an important aspect of the single market as envisaged by the Treaty that there should be currency stability as far as possible across the whole market, and the UK's conduct would be considered by the ECJ as imperilling the attainment of that central Treaty objective.

It must be stressed that the United Kingdom's legal position in this circumstance would be quite different from that of a member state, such as Greece, that was avowedly aiming for ERM entry, but was *unable* to achieve entry because of an excessive inflation rate or other factors. Trying but failing to converge is not a breach of the Treaty obligations in the same way (although the Treaty provides for remedial action), since the Treaty obligations are framed in terms of *policy intentions*.

The legal position would also be different if, owing to market forces, there were a total breakdown of the ERM. There would then be no system of fixed parities to which the UK could be expected to return, and no particular state could be blamed for defaulting on its obligations. Indeed, some have argued that it is safe to ratify the Maastricht Treaty because of their confidence that such a collapse will occur. The question of whether or not a general collapse will happen is an economic matter and therefore outside the scope of this paper. However, at the very least the possibility must be taken into account that such a general collapse will *not occur*. It would be very

strange to enter into a Treaty commitment on the basis that its central objective was bound to collapse, but this appears to be the position of some who support ratification but reject a return to the ERM.

What if the UK were to pursue a *stated* policy of intending to return to the ERM when conditions allow, but were to persist for an indefinite period in saying that conditions were unsuitable? This policy might work for a limited period, at the expense of creating suspicion, mistrust and ill-will amongst our Community partners. The British government is already in danger of creating a policy with two faces: a face turned towards Europe which says different things from the face turned towards the British Parliament and electorate. At Birmingham on 16 October 1992, the communique issued on behalf of the European Council by the UK as President called on member states to pursue convergence programmes 'to fulfill the criteria set out in the Maastricht Treaty in order to realise the movement towards economic and monetary union', and 'reiterated too, its commitment to the European Monetary System as a key factor of economic stability and prosperity in Europe.' The Maastricht criteria, set out above, of course include return to the ERM and maintenance within narrow bands without devaluation for a period of at least two years prior to the assessment preceding the start of Stage 3. On the other hand, four days after the Birmingham summit, the Prime Minister stated in television interviews that the UK would not return to the ERM for some considerable time and only if the ERM were to be substantially reformed.

Such a policy of expressing an intention to return to the ERM but never finding conditions quite right, or the details of operation of the mechanism quite right, could not be expected to work for very long. A stage would be reached when the UK's economic conditions would not objectively justify, in the view of the Commission, other member states or ultimately the ECJ, the UK remaining outside the ERM. In this respect, a country such as Greece has further to go before convergence in its inflation rate would make conditions possible for it to enter the ERM. Nor is it likely than an attempt by the UK to reform the ERM as a prelude to its return would be acceptable, since the UK has already agreed in the Maastricht Treaty to the framework of mutual obligations and institutional structures governing Stages 1 and 2 of monetary union.

The Treaty obligations considered above would of course apply, if anything with greater force, during Stage 3 of monetary union. Countries which had entered into the ECU block, such as, say, France, would have lost the possibility of ever devaluing against Germany. They would be likely to complain vociferously if their industries, rendered uncompetitive by being irreversibly yoked together in the ECU block with

stronger economies, were subjected to intense UK competition as a result of a sterling exchange rate to which they objected. Once Stage 3 had started the UK would, in common with countries with a derogation, be obliged to seek to maintain sterling within fixed parity bands against the ECU.

Consequences of breaching the Treaty

If the UK were held by the European Court to be in breach of its Treaty obligations by remaining outside the ERM, it is likely that the British government would be ordered to take steps designed to lead to ERM entry within a fixed period. If that order were to be breached, the Court could then impose fines on the UK under the new powers conferred by Article 171 of the Treaty of Rome as amended by the Treaty of Maastricht.

There could also be pressure amongst other member states to take retaliatory action, e.g. by imposing import levies designed to counterbalance the effects of an unwelcome sterling devaluation, although retaliatory action is frowned upon by Community law¹⁵.

The dubious benefits of opting out

The implications of the UK's Treaty obligations would appear to render its position, if opted out of Stage 3 monetary union, quite invidious. The UK would then be obliged by Treaty to seek to maintain a narrow band parity against the ECU block. However, the UK would be excluded from voting on the Governing Council which takes interest rate decisions for the ECU currency. The UK would be obliged to follow ECU interest rates in order to maintain its parity, but would have no say in setting them. This consideration renders the UK 'opt-out' from Stage 3 so unattractive that it must be queried whether its insertion in the Treaty can be regarded as anything more than an attempt at window dressing.

It is instructive to contrast the position under the present Rome Treaty. It would be compatible with the present Rome Treaty for a sub-group of countries within it to form a monetary union, using their own private treaty arrangements between themselves. However, other member states such as the UK would not be obliged to manage their exchange rates with the aim of achieving the Maastricht convergence criteria. Nor could the pursuit of such an exchange rate policy be made a condition of the UK's access to the single market.

In conclusion, if the Maastricht Treaty is ratified, it must be on the clear understanding that:

- (1) The Treaty will require the UK to return to the ERM after a limited period, and thereafter to seek to avoid devaluation within it;
- (2) The UK's position, if opted out from Stage 3 monetary union, will be so unattractive that the option looks unreal rather than practical. The UK would then be obliged in perpetuity to maintain itself in the ERM with the ECU block and to strive to avoid devaluation against the ECU, but would have no say in setting ECU interest rates.

Conclusions

The main conclusions of this paper may be summarised as follows:

1. The legal obligations of Stages 1 and 2 monetary union, which the United Kingdom is obliged to accept under the Treaty of Maastricht, will render it contrary to Community law for the United Kingdom to pursue an independent floating exchange rate policy for more than a limited period after the Treaty comes into force.
2. Pursuit of an independent exchange rate policy – especially if it resulted in a competitive sterling parity – would be expected to lead to complaints from other member states and/or the Commission about unfair competition and the damaging effects upon competitors this might have in the single market.
3. Prolonged failure by the United Kingdom to re-enter the ERM could result in the UK being taken before the European Court of Justice and being found to be in breach of its Treaty obligations. The UK would then be ordered to comply and could be fined if it did not do so.
4. Acceptance of the Treaty of Maastricht puts our Community partners effectively in a position to insist in the long term upon maintenance of an ERM exchange rate policy as a condition of access to the internal market.
5. In conclusion, the ratification of the Maastricht Treaty will lead to the following consequences:–
 - (1) The Treaty will require the UK to return to the ERM after a limited period, and thereafter to seek to avoid devaluation within it;
 - (2) The UK's position, if opted out from Stage 3 monetary union, will be so unattractive that the option looks unreal rather than practical. In that situation the UK would be obliged in perpetuity to maintain itself in the ERM with the ECU block and to strive to avoid devaluation against the ECU, but would have no say in setting ECU interest rates.

Notes

1. For a fuller account of the constitutional status of Community Law as part of the law of the United Kingdom, see 'Europe and the Constitution after Maastricht', Martin Howe, published by Society of Conservative Lawyers June 1992. The position was stated by Mr Justice Hoffmann in *Stoke-on-Trent v. B&Q* [1990] CMLR 31 (a Sunday trading case) at 34 as follows:- 'The Treaty of Rome is the supreme law of this country, taking precedence over Acts of Parliament. Our entry into the Community meant that (subject to our undoubted but probably theoretical right to withdraw from the Community altogether) Parliament surrendered its sovereign right to legislate contrary to the Treaty on the matters of social and economic policy which it regulated.'
2. Article 109e(1).
3. Article 109e(4).
4. Articles 104 and 104a.
5. Articles 109j(1).
6. Article 190j(2) and (3).
7. Article 109j(4).
8. Article 109k.
9. Article 109k(2).
10. Articles 109k(3) and (5); Article 43.1 of the Statute of the ESCB, which excludes 'derogated' member states from decisions on interest rate policy under Article 12.1 of ESCB Statute.
11. UK Protocol, para 10.
12. UK Protocol, para 5.
13. UK Protocol, para 6.
14. Interview, Wall Street Journal.
15. It is to be noted that the existing Treaty of Rome, in Article 107(2), permits the Commission to authorise other member states to take temporary measures to offset the effects of a devaluation.