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The Evolution of the European Monetary Union: A Success

The European monetary integration is the process of forming and blending together the monetary policies, exchange rates, and currency developments in Europe, with emphasis on Western Europe under the initiative of France and Germany. It constitutes an important part of a bigger picture: the economic and political amalgamation of Europe. For this reason the early history of the European Monetary Union (EMU) coincides with the history of the European Community (EC) and Union (EU).

The benefits of establishing a EMU are lower transaction costs in trade; elimination of the exchange rate risk in Europe; greater goods market integration and competition; formation of integrated European financial markets; preservation of inflation discipline; making more urgent the need for structural reforms in Europe. The costs of it are lack of monetary autonomy that can ease national shocks; little room for fiscal policy as a stabilization tool in the absence of independent monetary policy; no central system of federal taxes and transfers to insure against regional and national shocks. The actual process of integration imposes additional costs: the prisoner's dilemma. No one country would accede to give in more than the rest of the countries for the sake of a monetary unification: each of the countries pulls the carpet towards themselves when best for all is to throw away the carpet and get an insulation system. The bottom line is *the benefits of a monetary union supersede the costs therefore action should be undertaken*.

Action did take place, led by the familiar approach of trial and error. The fact that there were benefits and costs for the formation of a union generated substantial dynamics on the European economic arena, with major actors France and Germany. However, as in a good play the secondary actors are as important as the main ones, for a successful integration most of [Western] Europe needed to take some initiative. The road to the present state of affairs – the EMU, the Euro currency, the European Central Bank, and the European System of Central Banking – has been bumpy and discontinuous, and this is not even the finish line. However, progress has been made.

Monetary unions existed as early as in the 1800's when France conceived a monetary union with Belgium, Switzerland, Italy, Greece and Bulgaria, known as the Latin Monetary Union[1]. In the late 1800's the Scandinavian countries Denmark, Norway and Sweden introduced a monetary union according to which each of their currencies was accepted in each of the member-states as legal tender. World War I destroyed these unions. In the 1920's the Scandinavian countries reactivated their monetary union, offering accession to Finland. In the 1930's a conference was held in Eastern Europe with the goal of establishing a Union Monétaire Balkanique. It was to include Albania, Bulgaria, Greece, Romania, Yugoslavia and Turkey and was to be based on the gold content of the currencies of these countries. As the gold standard was abandoned in 1936 by all of Europe, the plan was also discarded.

Simultaneously plans for the introduction of European currency were proposed during the European Congress of Pan-European Movement in 1932. At the same congress the chairman of a German Bank Hans Fürstenberg put forward the idea of establishing a European Central Bank. The concept of a European Central Bank had been introduced earlier in the context of facilitating war debt repayments. It resulted in the establishment of the Bank of International Settlements (BIS) with the Young Plan of 1930, which constituted a first step in cooperation of central banks after World War I. However, BIS was not intended as a European Institution and its primary goal was to secure Germany's reparation payments. Thus, it left room for more sophisticated projects, such as Fürstenberg's idea of a European Central Bank. The criticism of it was that "the establishment of a European Central Bank would only be successful if it would have the authority to intervene in an authoritarian manner in the economic policies of each individual member"[2]. Europe was not ready for that. The next significant steps towards monetary unification occurred after World War II.

After the violent and destructive interruption of the planning for European monetary integration, and European integration in general, caused by World War II, in 1946 Churchill revived the idea of "United States of Europe". The Second World War reinforced the urgency for cooperation in the continent, and speeded up the efforts for integration.

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[1] http://www.dismal.com/euro/emu_history.stm

[2] P. 60 "European Monetary Union"

Churchill proposed a European framework in which French-German relations will be improved and the thread of the Soviet Union will be resisted.

Independently of this and in their own initiative in 1948 Belgium, Netherlands, and Luxemburg signed the Benelux Treaty. The United States of America also became involved in the European economic developments advocating a single market in Europe. At the Marshall conference in 1947 three main points were raised: regulation of European trade on a multilateral basis, broadening of the convertibility of the European currencies by creating a dollar fund, and making use of the German economic potential through a recovery program. The recovery program was adopted, known as the Marshall Plan (1948–1952) according to which seventeen European countries received aid in the length of four years. As a consequence the Organization for European Economic Cooperation (OEEC) came to life.

The United Kingdom was reluctant to engage herself in further integration. The rest of Europe, on the other hand, was eager about it. Jean Monnet came up with a plan for cooperation in heavy industry mainly between France and Germany but open to other countries. Robert Schuman presented it as the official French plan for cooperation. The United Kingdom rejected it. Benelux, Germany and Italy approved it and in 1951 the European Coal and Steel Community was founded between those countries. Six years later in 1957 the European Atomic Energy Community (Euratom) and the European Economic Community (EEC) were established between the same six countries. Since the customs union was successful, the Benelux countries decided on maintaining common exchange rate vis-à-vis third countries. In 1960 a new rival association EFTA was established including seven European countries that were not included in the EEC.

Once the economic premises for integration have been set up, the niche for monetary integration was opened. In 1964 the Committee of Central Bank Governors was founded with the objective to improve coordination of monetary policy among the Member states. It also decided that future adjustments of the exchange rates would be implemented only after mutual consultation.

The year 1969 marked the beginning of the intense planning towards an Economic and Monetary Union (EMU). In The Hague at a summit between the six leaders of EEC, led by the French Head of State Georges Pompidou, it was agreed to enlarge and deepen the

Community. Enlargement was to happen by opening the EC both for countries that have applied for membership earlier, as well as for members of EFTA. In terms of deepening the Community, EMU was determined as a final objective, realized in stages, to be completed in 1980. Pierre Werner, the Prime Minister of Luxembourg was assigned the task to prepare a report on the realization of EMU in stages. The Werner Report completed in 1970 stated the objective of EMU "to guarantee the growth and stability within the Community, to strengthen the Community's contribution to global economic and monetary equilibrium and to turn the Community into a stable bloc"[3]. Werner proposed a plan of ten years length and three stages. The first stage would consist of restriction of exchange rate fluctuations, and a beginning of coordination of monetary and fiscal policies between the governments. In stage two exchange rates fluctuations and divergences in price movements will be reduced further. In the third stage exchange rates will be fixed, national foreign exchange restrictions will be abolished and a community-wide system of central banks will be established resembling the American Federal Reserve System. The first stage was to start in January 1971. In March 1971 a Council Resolution was created with the following points being among the essential ones for a monetary union: 1. the total and irrevocable convertibility of the participating currencies, abolition of the fluctuation margins of the exchange rates and the permanent fixing of the exchange rate relationships – all prerequisites for the introduction of a single currency; 2. a system of central banks, which would evolve from the established European Monetary Cooperation Fund (EMCF).

After the dissolution of the Bretton Woods system the European currencies' exchange rates had been organized in a system of simultaneous intervention called the "snake" according to which currencies were allowed to fluctuate like snakes in a tunnel within a particular percentage rate. The percentage rate changed several times from up to 15% down to 2.5%. However, this method of currency relation was not successful. Part of the reason was the broad divergences in the economic performances of the countries involved. Because of her powerful economy West Germany's main goal was the restriction of inflation, while other countries with weaker economies emphasized that the restriction in inflation should not sacrifice growth rates.

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[3] Vanthoor, *European Monetary Union since 1848*

In 1979 an alternative system was established: the European Monetary System (EMS). It was not the monetary union proposed in the Werner report, but it was a step further towards monetary integration. It was paralleled by the European Currency Unit (ECU) and was a system of unilateral interventions vis-à-vis a third currency – the ECU. The ECU was guaranteed by the EMCF, to which the states contributed 20% of both their gold reserves and their dollar reserves. According to the exchange rate mechanism (ERM) each currency had a central exchange rate with the ECU and from this exchange rate the bilateral exchange rates between countries were derived. If a currency reached the maximum or minimum of its permissible range, the central bank had to intervene to correct the situation. The three main objectives of the EMS were to make exchange rate adjustments less complicated, to present a common monetary and exchange rate policy towards the rest of the world, with a European currency gradually emerging as a world currency along with the dollar, and to start the way to a full-scale monetary union. In practice the EMS served successfully only the first objective: the economies of the countries were too divergent to allow for a common monetary policy, and the ECU was not powerful/qualified enough to become a global currency.

The European Monetary Union was agreed upon in 1992 with the signature of the Maastricht Treaty. A list of convergence criteria was developed that had to be fulfilled in order for a country to be admitted to the EMU (see tables on last page). A European Central Bank was established, modeled after the German Bundesbank, with its primary objective to maintain price stability. The ECB works in cooperation with the European Union's 15 national central banks, which taken together comprise the European System of Central Banks (ESCB). The basic tasks of the central banks include defining and implementing monetary policy, conducting foreign exchange operations and holding and managing the official foreign reserves of the Member States.

The Maastricht Treaty also agreed on the formation of a new currency – the Euro. According to the Treaty the Euro is to be introduced in three stages. The first stage consisted in preparing for the Euro by coordinating the banking systems of the participating countries. The second phase began on January 1, 1999 by introducing the Euro as a currency for denomination of financial instruments. This date marked the official completion of the European Monetary Union. The final stage, still in the future – January 1, 2002 – consists

in starting the circulation of a physical currency, Euro notes and coins. During the first half of the year the Euro will be used simultaneously with the rest of the national currencies. On July 1, 2002, the Euro will become the only currency accepted as legal tender in the Euro zone.

The question that logically arises is whether the benefits of the European Monetary Union in reality do outweigh the costs of the carrying out of the project. An original answer to the question "Who gains from the switch [towards Euro]" was given by Gillian Tett in a Financial Times article:

> Not Europe's foreign exchange booths. But computer companies will see a surge in demand for their services, as systems are adapted to EMU. Accountants and management consultants may see surging demand for EMU advice. And companies, which print banknotes, have reasons to celebrate. And, of course, if you believe the EMU enthusiasts, all businesses should eventually benefit from the economic integration and stability, which a single currency could eventually deliver. That, after all, is supposed to be the whole point of this fiendishly complex project…[4]

Unlike Gillian Tett I believe in the idea of European Monetary Integration, both in itself and as an inseparable part of the economic and political integration of Europe. In itself, because transactions costs for trade within the Euro zone will fall, the volume of inter zone trade will increase, Europe being historically dependable on its exports; and it feels good to be able to take a 15 hour train ride and still be able to pay with the same currency. As part of the European integration, because a "citizenship of Europe" and "one European market" as proclaimed at the Maastricht Treaty would be unnecessarily complicated with a pocket of 15 different currencies.

Besides my inherent optimism for Europe's future, I base my opinion on a cost-benefit analysis[5]: it compares and relates the benefits and costs of the introduction of a single currency. According to this analysis, when the integration between countries rises, the benefits of a single currency rise and the costs of it fall. If graphed the relationship looks like a demand and supply curve (benefits and costs curve respectively), where 'x' is integration and 'y' is the costs and benefits as a percentage of GDP.

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[4] http://www.stern.nyu.edu/`nroubini/Emu/EMUGuideFT1196.htm
[5] P. 350 The Economics of the European Union

One reason for this relationship is the function of the exchange rate as a buffer of asymmetric shocks. If there is a shock in the demand for chewing gum of two countries, shifting the demand from French to German chewing gum, the French currency will be devalued in order to preserve domestic prices at the original level. However, as the two countries are more integrated, the French are going to keep chewing German gum and consume German goods, which makes the French basket of goods (CPI is measured as a basket) more expensive, which causes indirect inflation through decreasing the purchasing power of the French money without actually rising the nominal price level. This results in a wage-price-devaluation spiral offsetting the buffering effect of the exchange rate fluctuations. Note, if the countries are not integrated this offsetting process does not happen.

The benefits of having a single currency are that it decreases the costs of exchange for trade, travel, tourism, and investment purposes; it decreases the uncertainty for foreign investors – the fluctuations of the exchange rates becomes one less factor to worry about; it reduces market discrimination, which equalizes the economic levels of the different regions; it also makes Europe be represented by one currency, for example at G7 meetings becoming G3, instead of being represented by four different currencies whose interests do not always coincide with the pan-European interest.

The major cost of a single currency is less flexibility for shock absorption, because of no exchange rate mechanism and a unitary monetary policy. However, as mentioned, the costs of this fall with further integration. Also, there are alternative methods for shock absorption like community budgetary policy (similar to the federal budget in U.S.), national fiscal policies (e.g. less taxation for a region temporarily suffering a shock) and factor migration (labor mobility). Neither of those has been put into work yet, but all are options for the long run.

The idea of a single currency is wise, but it takes time for its benefits to start working full-scale. An adjustment period is needed. The beginning is going to be rough for the Euro-zone, but in the long run it will pay off as political and economic integration grow and as structural flaws are being overcome. It is like a medicine: you have to go through the bad taste in order to reach its beneficial contents.

Since the beginning of its introduction the Euro has been steadily depreciating revealing structural flaws of the system as well as weak economic performance of the Euro zone. Most people see trouble in the devaluation, and lack of confidence in the European currency. However, this also means higher exports for the European countries, which they need in order to comply with the convergence criteria and reduce their debts and deficits. You can't eat the cake and have it. You can't have a strong currency and high exports.

Indeed, there are also problems that the EMU is facing. A major one consists in the significant differences in economic performance of the countries within the Euro zone. Countries such as Spain, with a high growth rate (4.1%)[6] and a rising inflation rate (3.4%), need a restrictive monetary policy. While countries such as Italy, with a lagging growth rate (2.7%) and a stable inflation rate (2.6%) will benefit from an expansionary monetary policy. If monetary policy must stay the same then the countries are limited to their fiscal policy tool to shrink the divergences. Such problems, however are not insurmountable. The Maastricht Treaty allows citizens of the Euro zone to work anywhere they wish within the Euro zone. Greater labor mobility, enhanced by the EMU (easier wage comparisons and transferability by region), will contribute to an evening out of employment rates throughout the zone (e.g. people flowing from higher unemployment rate regions to ones with lower unemployment rate). This indirectly will equalize the rest of the economic indicators such as inflation (through the Phillips curve) and growth rate (less unemployment is associated with higher growth levels).

Europe has undertaken a complex project. The Werner Report prescribed 10 years for its completion; instead it took 30 (1969-1999). It is too early to evaluate the consequences of the EMU. However, the eventual fulfillment of the Werner Report's recommendations indicates that, despite obstacles and delays, Europe is capable of realizing her ideas; therefore one should trust her undertakings.

[6] The Economist, *Economic Indicators,* Dec 7th 2000