

# History of the european monetary union economics essay



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## **Introduction**

It has been almost 6 years since the euro was first introduced in 12 member states of the European Union on 1 January 2002. This date has left its mark in the European history and the entire world because it's the finalization with success of a very hard work initiated in Maastricht ten years earlier by the EU member states. Today, over 300 million Europeans use the euro as their currency and this number is to be increased widely in the coming years following the enlargement of the European Union to 27 countries. In these years euro has become also a recognized international currency that enjoys the kind of stability in today's global market. However, all this success of the euro as a stable currency has made notable changes in the economies of the EU countries that began to plan this event a little bit after the unification of the European Market in order to compete successfully in global markets. Also today after these years of Euro land we can also take our view regarding the success of the new currency and evaluate it based on facts and evidences.

## **A brief history of EMU**

There is no doubt that the first embryo of European Monetary Union was the theory of Optimum Currency Areas developed by R. Mundell in 1961 and R. McKinnon in 1963. It was the first work that served as model for the European Monetary System (EMS), which had provided the framework for the moves to Economic and Monetary

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Union. Following the good path of European Community, in 1970 was established the Werner Committee in order to prepare the right economic <https://assignbuster.com/history-of-the-european-monetary-union-economics-essay/>

environment for the monetary unification of the European Community. Although the EC countries supported this committee initially, it failed to pursue its goals and in 1979 led the way to European Monetary System (EMS). At this stage began the real efforts of the EC12 for the formation of the EMU. This stage includes a lot of agreements that European Community countries managed. Another milestone in the history of EMU is the Delors report prepared by Jacques Delors and presented in Madrid Summit in June 1989. His work led to the Maastricht treaty, which established the essential rules for the EMU. After its ratification in 1993 the way to the currency Unification was opened and clear for every European Union country. Monetary Union started in 1999 and for the first time in 2002 euro notes and coins were introduced finalizing the work of many decades.

## **Optimum Currency Area (OCA)**

**R. Mundell in 1961 and R. McKinnon in 1963 developed optimum Currency Area theory that is the model for the European Monetary System. This theory relates to a group of nations with currencies linked through permanently fixed exchange rates. The thing that makes this an optimum arrangement is that the currencies of the optimum currency area can float jointly against those of non-members. This removes exchange rate uncertainty, price stability, trade and investment. The downside of an OCA is that individual members cannot act independent economic policies for macroeconomic stabilization and growth since this would destabilize the fixed exchange rates.**

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## **Creation of European Monetary Union (EMU)**

When the Treaty of Rome was first signed by 6 European countries they did not seek Economic and Monetary Union but by the late 1960s and beginning 1970s, with the European Community well established, with already free tariffs and quotas, and the collapse of Bretton Woods system which retained gold as the ultimate source of value and dollar the only directly tied currency, they saw the possibility of a single currency and monetary union. Even though this was only a good idea and achieving this new objective was very hard for the EC at that time, because their economic performance, exchange rates and inflations were very different. At the beginning different views were launched by member states of EC in order to achieve the monetary unification and in order to resolve this problem was established the Werner Committee. It proposed the European Monetary Union, which included a number of stages to be followed in order to reach their goal of a single currency. The Werner Report contained a detailed description of the establishment of economic and monetary union in three stages up to 1980. The countries were gradually to increase the coordination of their economic policies and reduce exchange rate fluctuations. At the final stage exchange rates were to be locked irrevocably. In addition to a common monetary policy these plans also entailed that a number of fiscal-policy decisions were to be made jointly. However, the first plans for economic and monetary union were never realized because most EC members didn't maintain the narrow margins of fluctuations. The desire to promote greater economic integration of the EC-12 and coordinate their economic policies in controlling the inflation led the German Chancellor Helmut Schmidt and the French

President Valéry Giscard d'Estaing first to propose the European Monetary System (EMS) in 1978. A very

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important role and decisive role in the fast evolution of EMS gave the Single European Act. In the single market, goods, services, labor and capital had to move freely between member states in the same way as in the participating countries' domestic markets. The single market was aimed at promoting higher growth and lower prices through enhanced competition. To obtain the full effect of the single market, i. e. a large "domestic market" covering the entire EC, the provisions also contained a reference to economic and monetary union. However, it was not specified how this was to be introduced.

The main components of the EMS which was a very complex system are: first the European Currency Unit (ECU), second and the most important of all is the Exchange Rate Mechanism (ERM), third the Financial Support Mechanism (FSM), and the fourth and the last is the European Monetary Cooperation Fund (EMCF). The ECU was described as a basket of all EU currencies, the amount of each weighted according to its country's share of EU GDP (Baldwin & Wyplosz, 2004). The main advantage of ECU besides its purpose as a unit of account of the European Community was that ECU spread the risk of individual EU currencies changing in value. The ERM has been the core component and element of the European Monetary System. It is a system where authorities allow the central parity, and the associated maximum and lower levels, were the currencies linked to each other slide

regularly. When it was first introduced each currency was allowed to fluctuate by  $\pm 2.25$  per cent against its central rate, but for countries that have very difficult problems with inflation, followed by speculative attacks like Spain, Italy, Portugal and UK the margin was allowed to fluctuate by  $\pm 6$  per cent. Lack of appropriate domestic economic policy by governments to support stable exchange rates

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led to a series of exchange rates adjustments between countries within ERM. The growing stability that merged in ERM was created by the Deutschmark, which served as the cornerstone of ERM. But this tranquility collapsed by the exchange rates crises of September 1992, August 1993 and March 1995, which were mainly caused by the speculators who moved large amounts of capital within European Union. Based on these situations the ERM system changed from a pegging system to a system of management floating with bands widened from  $\pm 2.25\%$  to  $\pm 15\%$ . During this period UK and Italy leave the ERM system increasing the doubts for the future viability of ERM, but all these doubts fall in the Maastricht Treaty of 1993 where ERM system became a prerequisite for all members of European Union who wished to join the European Monetary Union. The phases of ERM were very difficult at their beginning because at that period each EC country worked with different interest rates made by their central banks.

## **Delors Report and the Treaty of Maastricht**

At an EC summit in Hanover in 1988 a committee was set up to prepare a report with proposals for the introduction of economic and monetary union

and thereby a single currency. The committee comprised Jacques Delors, then President of the European Commission and the governors of the central banks of all 12-member states at that time. The work of the committee concluded with the Delors Report in 1989. Like the Werner Report, the Delors Report proposed a transition to economic and monetary union in three stages. At a summit in Madrid in June 1989 it was decided to go ahead with the plan on the basis of the proposals in the Delors Report. It was also decided that the first stage of

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Economic and Monetary Union, EMU, was to start on 1 July 1990. Delors report identified three stages in the transition to economic and monetary union.

In the first stage members of the EC should converge and perform economically to a common level, create a single market and all the EC currencies to have joined the ERM. In the second stage, European System of Central Banks (ESCB) should emerge in EC taking a very important part in coordinating macroeconomic national policies and in stage three, the ESCB should assume greater responsibility for monetary policy, and the exchange rates totally fixed and rapidly replaced by a single currency.

Stage three mainly ensured to ECB total control to the foreign exchange rates and introduction of the single currency. This mentions that very little national autonomy was left for the central banks of the EC countries to operate with their monetary policy and based on this UK and Denmark

refused to agree it without a referendum. UK also argued that it was not <https://assignbuster.com/history-of-the-european-monetary-union-economics-essay/>

ready for the single currency because it had not yet a sustainable convergence economy with the other EU economies and was showing macroeconomic instability at that time.

At the Intergovernmental Conference at Maastricht in 1991 the Delors report was the basis for discussion on Economic and Monetary Union, and at the end it composed the Treaty of Maastricht, which relied mainly on the Delors Report with very few changes. The Treaty of Maastricht was the legal basis for the second and third stages of EMU. The aim in the second stage was to achieve more stable and uniform development within the EU. Member states were therefore to work towards meeting certain economic requirements, called the convergence criteria, which were incorporated

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in the Treaty of Maastricht. Among other things, member states were to limit their government budget deficits and government debt, and ensure price stability. At the start of the second stage, the European Monetary Institute, EMI, was established in Frankfurt am Main, Germany. The EMI was the forerunner of the European Central Bank. A very important part of stage two was also the Convergence criteria. It had five points that every candidate country in the EU should follow in order to join the EMU. They should maintain no higher inflation than 1.5 % above the average for the three EU members with the lowest rates during the previous years, achieve a long run interest rate of no higher than 2 % above the three EU countries with the lowest rates, exchange rates in normal band of the ERM for two years



without devaluing, budget deficit should not exceed 3% of their GDP and, national debt should not exceed 60% of GDP.

It was the second stage, especially the convergence criteria that create problems for the EU countries because for some of them reaching these criteria was difficult and in some cases impossible. Italy and other southern EU countries faced real difficulties in lowering inflation in the margins were the convergence criteria appointed because of severe speculative attacks. Taking in consideration these situations and the risk of many EU countries currencies, in 1993 the inflation rate band was enlarged to  $\pm 15\%$  in order to save the ERM and to give chance to Countries with inflation problems to get in EMU. Also the public debt criteria were very hard to manage by Belgium and Italy whose debts stood at some 120% of their GDP. Even though these countries faced such deviations from the criteria they negotiated and were accepted in the EMU but with the responsibility to lower their budgeted debt toward the 60% criteria. Although Italy left

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ERM system, it entered again because the ERM was a prerequisite for each EU to be member of EMU. Despite Italy's action UK and Denmark didn't join ERM, meaning that they remain outside the European Monetary System. UK still continues to argue that ERM membership is not a prerequisite if it should wish to join the EMU. Another particular and isolated case was Greece who was not initially part of the 11 countries that would adopt euro but who joins them with difficulty in 2000 after first entering ERM system.

## **The Introduction Euro, pros and cons**

On 1 January 1999, 11 EU member states acquired a single currency, the euro. This was achieved by locking the exchange rates for the legacy currencies of the participating EU member states (euro area member states) vis-à-vis the euro. Three years after the introduction of the euro, euro banknotes and coins were put into circulation. The three years up to 1 January 2002 were necessary in order that all parts of society, e. g. retailers, the financial sector, companies and the public sector, could prepare for the full transition to euro. This period was also used to manufacture euro banknotes and coins.

EMU offered to the member countries of the euro zone benefits but also many costs. The unification of the currency improves and reinforced the single market by permitting all transactions in one currency, which promote competition among EU countries and make the general EU economy more compatible in the world market. The single currency also attracted more inward foreign investment in areas less developed. In our case this action could be very valuable because will lead to economic growth of the

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region. By coordinating the monetary policy and economic variables such as inflation, EMU promoted greater economic growth. Also greater competition rose from the single currency and this offered better choices for European consumers, lower prices, and better quality. The EU expects that the unemployment rate will fall due to structural and regional changes bought by EMU. On the other hand we also have to mention the cost of the single

currency. The main cost of the EMU is that central banks of the EU countries lose the ability to pursue their own economic policies because now they operate in one level with EU policies. They are unable to use monetary policy because interest rates are determined by ECB, while fiscal policy is limited by the need to maintain the Maastricht public debt criteria lower than 60% once they are in a single currency.

### **How do the Europeans feel about euro?**

The inhabitants of the Euro land have very different aspects about the euro as a currency and they think that it has brought many changes in almost every aspect of life. Most of them (51%) recognize the adoption of euro as an advantageous event in their country. When asked in different surveys organized in the euro zone, citizens assume that the main advantages from the adoption of the euro are: easier and cheaper traveling (39%), facilitated price comparison (27%), and better status of Europe (23%). The overwhelming majority of the citizens that see euro as a disadvantage, thought that the introduction of euro has led to an increase in the prices and this is the main reason for their negative perception about euro. Even though the skeptics of the euro view it as not a good thing, the optimists link the economic growth with the euro and their debate over

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this issue will continue for a very long time and will raise for us the question about our future perspective if we will join or not the EMU.

## **Conclusion**

Do the disadvantages outweigh the disadvantages of the EMU? Do the EMU partners benefit from an economically united Europe or would they be better off on their own? Only time will tell. For what my opinion is worth, I tend to look at the idea of the EMU, the ECB, and a united Europe as an interesting economic, political, and social experiment. Like any experiment, unless you execute it, you will not see all the consequences it may bring. Probably only after a dozen years from now will we be able to fully see the outcome of this experiment. For now, it makes for an interesting Europe with virtually nonexistent boundaries.