# *European Economy: The Economic and Monetary Union*

*University College Dublin*

*Spring 2017*

## *The Economic and Monetary Union*

An important institution with regard to monetary integration is the Economic Monetary Union (EMU) which was established by the 1992 Maastricht Treaty.[1] The creation of the EMU, which also lay the foundation for the Euro, progressed according to three stages[2]

1. Stage 1, starting in July 1990
   - Complete freedom of financial transactions
   - Increased cooperation between central banks
   - Free use of the European Currency Unit (ECU)[3]
   - Improvement of economic convergence
2. Stage 2, starting in January 1994
   - Establishment of the European Monetary Institute
   - Ban on granting of central bank credit
   - Increased cooperation on monetary policies
   - Strengthening of economic convergence
3. Stage 3, starting in January 1999
   - Fixing of currency exchange rates
   - Introduction of the Euro
   - Conduct of the single monetary policy by the European System of Central Banks
   - Entry into effect of the intra-EU exchange rate mechanism.[4]
   - Entry into force of the Stability and Growth Pact

The key aspects of the Maastricht Treaty that created the EMU was to

1. Guarantee price stability
2. Create an independent central bank.

You can imagine that, as with most European affairs, getting the countries to agree on the best policies to achieve price stability and more importantly for countries to give up their monetary autonomy

[1] The decision to form a monetary union was taken in 1988.

[2] Taken from the history section on the EMU webpage.

[3] The ECU is the forerunner of the Euro.

[4] This is ERM II.

involved a lot of difficult negotiations. In the end however the agreed policies were mainly created in the image of, or according to the preferences of, Germany. Germany had recently reunified and was the largest economy in Europe and had a very strong currency in the Deutschmark. As such it had to be persuaded to abandon its own currency in favour of a single common currency, joining the Euro project.[5] Before we discuss the EMU in more detail it is good to take a step back and look at the European Exchange Rate Mechanism which was established in preparation of the EMU.

[5] Some argue that joining the EMU was the price Germany had to pay for reunification.

## *The European Exchange Rate Mechanism*

The ERM was established in order to help stabilise exchange rates across the member countries. It provided a central exchange rate against the ECU, which in turn provided a cross-rate for all the currencies against each other. The hope was that the ERM would help increase trade within Europe and control inflation.[6] Given the use of the ECU as a benchmark currency, the ERM was based on the idea of a fixed exchange rate albeit with margins on either side of the central exchange rate. In practice this meant that each currency had a target zone in which the value of the currency could fluctuate relative to the ECU. A problem with the design of the ERM was that countries tried to retain their monetary policy autonomy which resulted in different inflation rates.[7] As such the ERM had to be realigned a couple of times which lead to several speculation crises.[8] Due to the destabilising nature of these realignments, countries that were prone to high inflation tried to bring down inflation rates basically by adopting the policies of the German Bundesbank, which became the ERM standard. This went quite well for a while, between 1987-1992 there was no realignment, but would eventually lead to a major crisis and the break down of the ERM. Given that the Deutschmark served as an anchor for the whole system, this meant that the Bundesbank had full autonomy; a system that was meant to be symmetric became asymmetric. This had two important implications

[6] The 1970s were a period that was characterised by a lot of volatility.

[7] Recall that the objective was to control inflation.

[8] The market could anticipate on these realignments selling off currencies.

1. The Bundesbank leadership wasn't very popular with the other countries[9]
2. The 1991-1992 crisis

[9] The other countries were of the opinion that monetary policy should be shared collectively and not be given to one national central bank

Although the 6-years without realignment seemed to be a good sign, a problem was that inflation rates didn't really converge across the board. Countries such as France moved towards the German inflation rate, but this didn't apply to for instance Italy. This meant that for countries with high inflation rates their national currencies kept appreciating, resulting in a loss of competitiveness. Eventually three events brought down the ERM

1. German reunification
   - Reunification was likely to lead to inflation due to the state of East Germany
   - The Bundesbank raised the interest rate in response to quell the risk
   - Some countries decided not to raise the interest rate due to economic slowdown, this triggered speculative attacks on countries that had lost competitiveness.
2. Denmark rejecting the Maastricht Treaty
   - The Danes were the first to ratify the treaty
   - However the population voted against it, sparking fears of contagion
3. French referendum
   - Similar to Denmark, France held a referendum and the polls didn't look good
   - This sparked unrest in the exchange market
   - Specifically the Italian Lira and British Pound were targeted as they were overvalued.[10]

[10] The British taxpayer lost 3.3 billion Pounds.

Following these events the ERM was redesigned (ERM II) basically widening the margin which leaves more room for monetary policy autonomy. At the moment the only member of the ERM II is Denmark.

## *Main principles of the Economic and Monetary Union*

Going back to the EMU itself, the union is based on three main principles

1. Provide price stability
   - Objectives of most central banks is to keep inflation between 1.5-2 percent over the medium term (2-3 years)
   - In the long run monetary policy will only impact inflation, while in the short run it will also affect growth an unemployment
2. Central bank independence
   - To operate effectively, the central bank should be able to do its business without outside interference

Surprisingly, the treaty itself doesn't offer a definition for price stability. However, in the Eurosystem it is defined as

> "the year-on-year increase in the Harmonised Index of Consumer Prices for the Eurozone of close to but below 2 per cent. Price stability is to be maintained over the medium term"

- The central bank's main aim nowadays is price stability whereas others[11] don't mind higher inflation rates

[11] Read government

3. Fiscal discipline
   - This is an important point as governments could create conditions that undermine the actions by the central bank
     - E.g. the government could lend from the banks and if the deficits become large enough, create a financial crisis.
     - So the government could spend now, to create goodwill with the population, and tax later after the elections, or never.
   - In a monetary union the government could be waiting for fiscal transfers
   - The treaty includes a clause on this which led to the Stability and Growth Pact

See the lecture on Optimum Currency Areas

We will discuss this in a future lecture.

*EMU entry conditions*

Importantly, entry to the EMU, and the Eurozone, is not based on the criteria set out by the optimum currency area theory. Instead European leaders decided to use another set of conditions. This allows any EU member state to join when they have shown to be able to behave according to the guiding principles of the Maastricht Treaty. There are five entry conditions

Countries that wish to join the EU are actually obliged to join the Euro.

1. Inflation
   - The inflation rate should not exceed the average of the three lowest inflation rates achieved by the EU member state by 1.5 percentage points
2. Long-term nominal interest rate
   - The long-term interest rate should not exceed by more than 2 percentage points the average observed rate of the three lowest inflation rate countries
   - This is to deal with possible cheating on the first condition where countries can squeeze prices temporarily

This follows the Fisher principle where the nominal interest rate equals the real interest rate plus the expected inflation.

3. Exchange Rate Mechanism (ERM) membership
   - Countries should have taken part in the ERM at least two years without having to devalue its currency
4. Budget deficit
   - Budget deficit should not exceed 3 per cent of GDP.
   - The budget deficit should correspond to public investment which is a source of economic growth

This entry condition is a result of German preferences who are somewhat squeamish about inflation rates since the hyperinflation in the 1920 that hit the Weimar Republic.

5. Public debt
   - Public debt should not exceed 60% of GDP
   - The 60% threshold was taken since it was the average level when the treaty was negotiated in 1991
   - There is actually a clause stating that it is 60% "or moving in that direction".

Note that the deficits can be altered by shifting around public spending and tax revenues.
This is due to Belgium who had a public debt that exceeded 60%.