EU Economics: The European Monetary Union

University College Dublin

Spring 2017

The European Monetary Union

An important institution with regard to monetary integration is the European Monetary Union (EMU) which was established by the 1992 Maastricht Treaty. The EMU, which lay the foundation for the Euro, focused on the need for

1. Price stability
2. An independent central bank.

As with most European affairs, establishing the EMU involved a lot of difficult negotiations and in the end it was created mostly in the image, or preference of, Germany. Since Germany had the largest economy in Europe and a strong currency in the Deutsch Mark, it had to be persuaded to abandon its own monetary policy and join the Euro in the long run.

Main principles of the European Monetary Union

The EMU 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)
   - Note that in the long run monetary policy will only impact inflation. In the short run monetary policy will affect other economic variables such as growth and unemployment.
2. Central bank independence
   - To operate effectively, the central bank should be able to do its business without outside interference
   - The central bank's main aim nowadays is price stability whereas other segments of society (read the government) have short-term preferences for inflation
3. Fiscal discipline
   - This is an important point as governments could create conditions that undermine the actions by the central bank (see also the second principle)
     - For instance the government could lend from the banks and if the deficits become large enough, create a financial crisis

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"

  - Basically the government can 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 Optimal Currency Areas

We will discuss this in a future lecture.

The European Monetary Union and Optimal Currency Area conditions

Importantly, entry to EMU and the Eurozone are not based on OCA conditions.

Instead, the European leaders decided to use another set of conditions, allowing basically any EU member state to join when they have shown that they can behave according to the guiding principles of the Maastricht Treaty. Currently, 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 by shifting around public spending and tax revenues.

This is due to Belgium who had a public debt that exceeded 60%.