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Briefing

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A history of European monetary integration

SUMMARY

European monetary integration began almost a decade after the Treaty of Rome, as European Economic Community Member States sought to protect themselves better from international economic turbulence and loosen their ties to the US dollar.

This process, in which a multitude of stakeholders (Member States, European institutions) was involved, developed from looser forms – such as the 'Snake in the tunnel' mechanism – to Monetary Union and a common currency with an international role and importance.

Although the Monetary Union brought many benefits to Member States during its first decade of existence, the crisis that began in 2008 has led many to call into question its usefulness. Despite the controversy, it is useful to recognised that much has been achieved, that monetary integration is still a 'work in progress' and that its ultimate success or failure will depend on many factors, not only economic, but also political.

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Introduction – From the Gold Exchange Standard to Bretton Woods

European countries were trading long before the introduction of 19th century monetary standards such as bimetallism, or the Gold Standard. Nevertheless, the adoption of these standards (considered by many to be a form of fixed interest rate), added to the industrial revolution and a period of great technological innovation, resulted in an unprecedented increase in trade and economic transactions between states in the 1800s. The First World War and the ensuing deterioration in the political and economic environment on the European continent during the interwar period – economic stagnation, inefficient allocation of resources which were channelled to the preparation of another conflict, 'beggar-thy-neighbour' policies manifested through currency devaluation and protectionist measures – led to the end of the Gold Standard and to a deterioration in cooperation between countries which persisted until the signature of the Bretton Woods Arrangement in 1944.

From Bretton Woods to the Werner Report

According to Michele Chang, 'the Bretton Woods system was based on the idea that international economic transactions should be promoted via free trade and fixed exchange rates'. The latter were introduced with the dollar exchange standard, under which the dollar was fixed to gold at the price of US$35/ounce and the other currencies were fixed to the dollar. The agreement was signed in 1944, but did not come into operation immediately because, after World War II, many currencies were not convertible and trade was only conducted under non-transferable bilateral credit lines between countries. To supervise the distribution of aid under the Marshall Plan and to resolve this issue, the Organisation for European Economic Cooperation (OEEC) and the European Payments Union were created in 1948 and 1950 respectively.

By the time the Treaty of Rome was signed in 1957, convertibility was restored and the European Monetary Agreement was established; under this agreement, a European Fund and a Multilateral System of Settlements were created to help members facing balance of payment problems and to facilitate the settlement of transactions between them. In this context, the Treaty did not provide for the monetary organisation of the European Economic Community (EEC). Instead, more importance was given to the establishment of a common market, a customs union and common policies and only limited steps (like the Marjolin Memorandum in 1962, which launched discussion on a common currency and prompted several measures in the field of monetary cooperation[1]) were taken at European level.

However, tensions began to build as the US experienced balance of payment problems, which led to doubts about the stability of the dollar and in general the stability of the international monetary system as set out at Bretton Woods.

The Werner Report

The situation worsened in 1968-69, when market turbulence forced a revaluation (rise in value) of the German mark and devaluation of the French franc. This endangered the common price system of the Common Agricultural Policy (CAP) and had a negative effect on the intra-Community and international trade of Member States. As a result, the Heads of State or Government requested the Council to draw up a plan for closer monetary integration. The resulting Werner Report, published in 1970, was an

ambitious plan, which set out a three-stage[2] process to achieve economic and monetary union within a ten-year period.

The integration strategy outlined in the Werner Report was based on the assumption that exchange rates to the US dollar would remain stable. This proved not to be the case, as in August 1971 the United States decided to temporarily suspend the dollar's convertibility into gold. Even though the plan was never fully implemented, its principles (staged introduction, transfer of decision-making powers on economic policy from the national to the Community level) set the framework for further steps towards monetary integration.

Under the Smithsonian agreement of December 1971, the dollar was devalued by 8.6%,[3] the major currencies appreciated[4] and the margin of exchange rate fluctuation vis-à-vis the US dollar was set at +/-2.25%. This, however, could create significant fluctuations between EEC countries that were party to the agreement (e.g. the fluctuation of their currencies could lead to a maximum spread of 4.5%), something that, just as in 1969, created major risks for common policies such as the CAP. To solve this problem, the EEC members decided to shift their focus, to weaken their ties to the dollar and reduce intra-Community currency fluctuation margins.

The 'Snake-in-the-tunnel' and the European Monetary System

On 24 April 1972, EEC central-bank governors concluded the 'Basel Agreement', creating a mechanism called the 'Snake in the tunnel'. Under this mechanism, Member States' currencies could fluctuate (like a snake) within narrow limits against the dollar (the tunnel) and central banks could buy and sell European currencies, provided that they remained within the fluctuation margin of 2.25%. The original participants in the mechanism were France, Germany, Italy, Luxembourg and the Netherlands. Denmark, Norway and the United Kingdom joined shortly afterwards.

The first oil crisis in 1973, as well as weak compliance and frequent Member State departures from the scheme,[5] led to the 'Snake' mechanism's failure. Nonetheless, the momentum built over the previous decade endured, and efforts to create an area of currency stability continued. A new proposal for monetary union was put forward in 1977 by the then President of the European Commission, Roy Jenkins, but was met with scepticism. A more limited form was supported by the French President Valery Giscard d'Estaing and the German Chancellor, Helmut Schmidt and was launched as the European Monetary System (EMS) in March 1979 with the participation of eight Member States.[6]

The basic elements of EMS were the definition of the European Currency Unit (ECU) as a basket of national currencies and an Exchange Rate Mechanism (ERM), which set an exchange rate towards the ECU for each participating currency. On the basis of those 'central' rates, bilateral rates were then established among Member States.[7] The system also included a preventive tool[8] to avoid breaking the set exchange rates.

The early years of the EMS saw modest results. According to experts, the turning point came in 1983 when the 'French government decided to follow a *franc fort* policy, in which monetary policy closely followed that of the German government and became increasingly market oriented.'[9] By committing to EMS discipline, France and other inflation-prone countries achieved a reduction in inflation and their interest rates converged to a lower level.

Towards an Economic and Monetary Union

During a period of intensifying efforts to create a single market (from the adoption of the Single European Act (SEA) in 1986 to its completion in 1992, the costs created by the existence of several currencies and unstable exchange rates became more evident. In this context, France and Italy led initiatives[10] for stronger European cooperation. This resulted in the European Council setting up in June 1988 a Committee for the Study of Economic and Monetary Union, chaired by Commission President Jacques Delors. The Committee's report, submitted in April 1989, defined the objectives of monetary union[11] and indicated that they could be achieved in three stages.[12]

The Madrid European Council of June 1989 decided to proceed to the first stage of EMU in July 1990, and the 1989 Strasbourg European Council in December called for an Intergovernmental Conference to determine the Treaty revisions that would be needed to move to the second and third stages and implement the Economic and Monetary Union. With the fall of the Berlin Wall just a month before, the political climate in Europe was remarkably conducive to stronger integration.

Thus, in December 1991, the Heads of State or Government meeting in Maastricht approved the Treaty on European Union, declaring that they were 'resolved to achieve the strengthening and the convergence of their economies and to establish an economic and monetary union including, in accordance with the provisions of this Treaty, a single and stable currency'. The Treaty provided for the introduction of a monetary policy (Article 3a TEU), implemented by a single and independent central bank (Article 4a TEU), with price stability as a primary objective. It provided legal grounds for the establishment of a single currency, the ECU (Article 3a TEU). Finally, the Treaty set convergence criteria[13] which each Member State had to meet in order to participate in the third stage of Economic and Monetary Union (EMU).

Despite these stabilisation efforts, the destabilising effects of deregulating international financial capital movements under the SEA, and the diverging national monetary and fiscal policies of EMS members (e.g. the UK and reunified Germany) combined with uncertainties related to the ratification of the Maastricht Treaty (following its rejection by referendum in Denmark and difficulties in its ratification in France), led to increasing market speculation, culminating in a currency crisis during 1992-93, forcing some Member States (the UK and Italy) to leave the ERM and some others (Spain and Portugal) to devaluate their currency. In an effort to restore stability and discourage speculation, Member States decided in August 1993, to temporarily widen the ERM margins to +/-15%.[14] This move, as well as the positive result of the second referendum in Denmark (after the Edinburgh Agreement and its opt-out from the EMU) eased tensions and the project went forward with the creation of the European Monetary Institute, charged with ensuring the coordination of Member States' monetary policies and providing surveillance.

According to Michele Chang, by April 1994, 'none of the EU Member States had fulfilled the convergence criteria' and 'all Member States, save for Ireland and Luxembourg, were found to be in breach of the deficit targets'. Nevertheless, the Cannes European Council in June 1995 confirmed that the year 1999 would be the starting date for the Economic and Monetary Union and European leaders at the Madrid European Council in December decided to name the new European currency the 'euro'.

With the date for the launch of the EMU approaching, public scepticism towards monetary integration grew, especially in Member States with strong currencies, like Germany, which were concerned about maintaining price stability. At the same time, other countries such as France and Spain were more concerned about growth than price stability. This led the European leaders' meeting in Dublin in December 1996 to propose a Stability and Growth Pact, which was a compromise between a German proposal for the creation of a Stability Pact – which would maintain convergence obligations after Member States joined the euro area – and the French, Spanish and Italian concerns that excessive focus on budgetary discipline would be at the expense of growth.

In June 1997, the European Council adopted a Resolution to set up an exchange rate mechanism after the creation of the euro area in 1999. This mechanism, called 'ERM II' because it essentially replaced the ERM mechanism of the EMS, fixed the exchange rate of non-euro area Member States against the euro and allowed it to fluctuate only within set limits, to ensure that exchange rate fluctuations between them would not impact on the economic stability of the single market. Meanwhile, the Member States considerably increased their efforts towards convergence: whereas in 1997 only Finland, Luxembourg and Portugal had achieved all the convergence criteria,[15] by May 1998, the Council decided that 11 Member States[16] satisfied the necessary conditions.[17] Finally, in July 2000, the Council agreed that Greece also fulfilled the convergence criteria – although it needed to continue the intensive structural reforms undertaken – and could therefore adopt the single currency.

On 1 January 2002 the euro became legal tender in the participating countries and by the end of February 2002 national banknotes and coins ceased to be legal tender. Since then, the euro area has undergone six rounds of enlargement – Slovenia in 2007, Cyprus and Malta in 2008, Slovakia in 2009, Estonia in 2011, Latvia in 2014 and Lithuania in 2015 – bringing the number of member countries to 19. There are currently nine EU Member States whose currency is not the euro.[18] Of those nine Member States, Denmark and the United Kingdom have a special status (based on 'opt-out clauses'), whereas the other seven are prospective candidates for adoption of the euro (i.e. 'Member States with a derogation') and have committed to joining the euro area as soon as they fulfil the entry conditions. Today, the euro area covers a population of 335.4 million (as opposed to 316.5 million in the US), its share of world GDP is 12.1% (16.5% for the US) and its GDP per capita is equal to €28 600 (versus €41 200 for the US).

The euro area before the crisis

The years between the introduction of the euro and the global financial crisis are generally considered as a positive period for euro-area economies. According to Mongelli and Wyplosz, the value of imports and exports of goods within the euro area increased from 26% of GDP in 1998, to 33% of GDP in 2007. In the same period, intra-euro area services trade also went up, from 5% to 7% of GDP. Baldwin, Skudelny and Taglioni found that the EMU had a significant impact on trade flows with non-EMU countries: third countries traded up to 27% more with EMU countries since the creation of EMU. Inflation rates dropped and converged among euro-area countries.[19] Mongelli and Wyplosz observed that this price stability benefited consumers and companies. Moreover, low interest rates have lowered the cost of servicing high public debts.[20] Philip Lane notes that EMU has been associated with 'a substantial increase in cross-

border financial integration across the euro area' which in turn, 'has stimulated financial development (...), through the lowering of transactions costs and the expansion in the volumes of financial assets'. Sebnem Kalemli-Ozcan, et al. observe that transaction costs in equity and corporate bond markets have fallen considerably, whereas spreads in government-bond markets have narrowed and tended to move together. While retail banking activities remained fragmented, interbank markets have shown considerable integration.

Some researchers however, debate whether the intensified trade and financial integration has increased the general welfare[21] of European citizens: Francesco Caselli, for example, compares EMU countries to the rest of the OECD countries[22] and has found that, in fact, GDP per capita increased at a *slower pace* in EMU countries in the period up to the crisis.

The crisis – causes and responses

Although the definitive causes and mechanism of the crisis are still debated, many economists tend to agree on the following causes:

- under-pricing of risk by credit rating agencies and the financial markets, which allowed prices of government bonds in the euro area to converge;[23]
- non-enforcement of the fiscal coordination framework in place (the Stability and Growth Pact), which encouraged some Member States to adopt irresponsible fiscal policies, instead of focusing on the necessary reforms to remain competitive;[24]
- growing government spending in several Member States, concealed for many years by 'artificial' tax revenues coming from a booming construction sector reliant on property 'bubbles';
- the complacent attitude of many euro area banks, leading them to acquire large portions[25] of sovereign debt of the countries of the 'periphery', contributing to 'powerful negative feedback loops'[26] between banks and sovereigns, and excessive exposure to risks in the periphery by banks in the core.

Euro area Member States and institutions are fighting the crisis on different fronts: economic governance was strengthened through a number of initiatives;[27] at the same time, facilities and mechanisms were created to provide assistance and support to Member States in financial difficulties[28] and a Banking Union was founded, to restore financial stability in the euro area, through a safer financial sector and a better-integrated banking system; finally, non-standard monetary policy measures were introduced,[29] to maintain price stability, stabilise the financial situation and limit financial contagion to the real economy. Thus, financial system collapse was avoided, while foundations were laid for the sector's long-term stability.

Conclusion

European monetary integration refers to a 30-year long process that began at the end of the 1960s as a form of monetary cooperation intended to reduce the excessive influence of the US dollar on domestic exchange rates, and led, through various attempts, to the creation of a Monetary Union and a common currency. This Union brings many benefits to Member States. However, over the past decade, the build-up of macroeconomic imbalances, and the imprudent fiscal policies of some Member States, resulted in the continuing double crisis (banking and sovereign). As a result of this crisis, many individual Member States face difficult re-adjustment processes, and Member

States collectively must reappraise the governance architecture of Monetary Union and adopt new mechanisms to detect, prevent, and correct problematic economic trends.

Whatever one's opinion on the process and the outcome of European monetary integration, it is still remarkable that so much progress has been achieved. It should also be kept in mind that 1999 was not the end of the process of monetary integration, as the adjustments during the first decade and during the financial and sovereign debt crises have shown. It is rather a 'work in progress' and its ultimate success or failure will depend on many factors: not only economic, but also political.

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Endnotes

[1] According to F. P. Mongelli 'Under the provisions of the memorandum, a Committee of Governors (CoG) of the national central banks of the EEC was established in 1964 and started meeting in Basel. (...) It was this committee that prepared the first draft of the Statute of the ECB in 1990.'

[2] The first stage involved reducing currency fluctuation margins in Europe, the setting of broad Community-level economic policy guidelines, fiscal policy coordination and changes to the Treaties of Rome. The second step, referred to financial market integration, removing capital restrictions, eliminating exchange rate fluctuations and short-term economic and fiscal policy coordination. The final step included the irrevocable setting of exchange rates, economic policy convergence and a Community-level system of central banks.

[3] It devalued to US$38 per ounce from US$35 per ounce of gold.

[4] The Japanese yen appreciated 17%, the German mark 13.5%, the British pound 9%, and the French franc 9%.

[5] Italy withdrew from the 'Snake' in February 1973, while France withdrew in January 1974, re-entered in July 1975 and definitively abandoned the mechanism in March 1976. Denmark and the UK joined in May 1972 only to withdraw in June.

[6] Belgium, Denmark, France, Germany, Ireland, Italy, Luxembourg and the Netherlands.

[7] The fluctuation margins around those bilateral rates were fixed at +/- 2.25% for all currencies, except the Italian lira, for which it was set at 6%

[8] Once the exchange rate of a currency reached 75% of the maximum authorised fluctuation margin, the respective country had to act through interest rate and fiscal policy adjustments. If those adjustments had no effect and the maximum fluctuation margin was reached, then and only then had central banks to intervene by buying or selling the currency.

[9] See also R. Solomon 'The Birth of the Euro and Its Effects'.

[10] See Dumas memorandum and Italian memorandum, in M. Chang, p. 34.

[11] Complete liberalisation of capital movements, full integration of financial markets, irreversible convertibility of currencies, irrevocable fixing of exchange rates, and the possible replacement of national currencies by a single currency.

[12] In the first stage, from 1990 until 1994 the internal market would be completed and restrictions on further financial integration would be removed. In the second stage, from 1994 to 1999, the European Monetary Institute would be established to strengthen central bank co-operation and prepare for the European System of Central Banks (ESCB), the transition to the euro would be planned, the future governance of the euro area would be defined and economic convergence between Member States would be achieved. Finally, in the third stage, from

1999 onwards, final exchange rates would be fixed and the transition to the euro take place. The ECB and ESCB would be established and binding budgetary rules would be implemented in Member States.

[13] Price stability, sound public finances, sustainable public finances, durability of convergence and exchange rate stability. The criteria most referred to are the ones relating to public finances: government deficit to gross domestic product (GDP) < 3% and gross government debt to GDP < 60%.

[14] Although Germany and the Netherlands agreed bilaterally to keep their currencies within the +/- 2.25% margins.

[15] See P. Du Bois 'Histoire de l'Europe monétaire 1945-2005', p.133.

[16] Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain.

[17] Although, it must be mentioned that six Member States, i.e. Austria, Belgium, Ireland, Italy, the Netherlands and Spain, exceeded the criterion of 60% of GDP in government debt.

[18] Bulgaria, Croatia, the Czech Republic, Denmark, Hungary, Poland, Romania, Sweden and the UK.

[19] According to OECD statistics – can be customised.

[20] As an example, in 2008, Belgium's debt was 90.8% of GDP, Italy 102.5% and Greece 103.4%.

[21] As measured in GDP per capita. A rise in per capita GDP signals growth in the economy and tends to translate into an increase in productivity.

[22] For the purposes of his comparison he assumes that the 'euro area' and the 'rest of OECD' subsets are similar.

[23] As an example, in 2008, Greek long-term interest rates were at 4.8%, versus 3.98% in Germany and 4.36% in Spain, whereas Greek total central government debt was 110.6% of GDP, versus 39.6% for Germany and 33.7% for Spain respectively. Source: OECD.Stat Extracts

[24] See for example the difference in unit labour costs – a conventional measure of national competitiveness – in some euro area economies over the past decade.

[25] In a paper published in August 2010, A. Blundell-Wignall and P. Slovik estimated that 'The exposure of Greek banks to Greek sovereign debt represents 226% of their Tier 1 capital. (...) Large cross-border exposures (defined as an exposure above 5% of Tier 1 capital) to Greece are present for Germany, France, Belgium (all with systemically important banks), Cyprus and Portugal.'

[26] The loop is the following: the risk of a banking crisis leads to an increase in the yield – that is, the amount of return investors can expect – of government bonds. Given that the movement in bond yield is inverse to its price, this increase pushes the prices of bonds down, which impacts on the balance sheets of those that hold those bonds. This, in turn, increases the risks that a systemic crisis will happen, and so on.

[27] The European Semester, the Six-pack and Two-pack and the Treaty on Stability, Coordination and Governance.

[28] The European Financial Stability Facility and the European Financial Stabilisation Mechanism, which have been replaced by the European Stability Mechanism.

[29] The Enhanced Credit Support, the Securities Markets Programme, the Outright Monetary Transactions, and the Expanded Asset Purchase Programme, to name but a few.

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