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Lecture 16: The European Monetary Union

I. OVERVIEW

- In the last lecture, we examined the circumstances leading up to the demise of the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS) in 1992. Following the ERM crisis, the exchange rate bands were widened to + or - 15% - this system became known as ERM II.
- The wider bands, coupled with the general convergence of inflation that had taken place by 1994, meant that there was much greater macroeconomic stability within the EMS from 1993 to 1998. By the end of 1998, 11 European countries made the transition from the EMS to EMU: European Monetary Union, joined in 2001 by Greece.
- Today's lecture examines the basic features of EMU, with an eye on establishing its advantages over the previous system. In the next lecture, we will look at the economic arguments that underlie the potential success or failure of the EMU and try to gauge what the future holds for it.

II. THE ROAD TO EUROPEAN MONETARY UNION

The Maastricht Treaty

- One of the most important developments in the road to EMU, one that even preceded the collapse of the ERM, was the 1991 establishment of the Maastricht treaty.
- The Maastricht treaty laid the groundwork for transforming from the ERM to EMU by the creation of a common currency (the Euro) and a new monetary policy maker (the European Central Bank).
- The Maastricht treaty laid out 5 conditions for joining monetary union.
  1. Currencies have to remain within the ERM bands for at least 2 years with no realignment.
  2. Inflation rates have to be less than 1.5% above the average of the 3 lowest inflation economies.
  3. Long term interest rates can't be more than 2% higher than the 3 lowest interest rate countries.
  4. Budget deficit can't be more than 3% of GDP.
  5. Government debt could not exceed 60% of GDP.
- The original plan called for starting EMU at the end of 1996 but since few of the countries had satisfied these conditions, a decision was made to delay until Jan 1st 1999 to allow countries to satisfy the criteria. Some of the criteria were decidedly flexible, the final decision on whether to admit a country or not was left up to the members of the European Council of Ministers.

- In 1992, after Britain and Italy left the ERM, the remaining countries moved to a system that increased the bands to + or - 15%, effectively signaling the arrival of floating exchange rates and effectively the demise of the ERM.
- The response to the collapse of the ERM was different across countries: countries like the U.K. moved away from fixed towards flexible exchange rates while France, Germany and Italy among others joined the much less stringent ERM II and moved towards full monetary union, ratifying the Maastricht treaty,

Party Like Its 1999

- On January 1st 1999, 11 countries embarked on what the Economist called "an awfully big adventure". The 11 countries that made up the EMU were France, Germany, Italy, Belgium, the Netherlands, Luxembourg, Portugal, Spain, Ireland, Finland and Austria. They were joined by Greece in January 2001, making a grand total of 12 members.
- The new EMU would have a new currency, known as the Euro. The Euro, unlike the ECU would become both a medium of exchange and a unit of account. However, for the first couple of years, it was part of a somewhat convoluted interim system.
- From January 1st 1999, the exchange rates of the EMU member countries were irrevocably fixed against the Euro. Between Jan 1st 1999 and Jan 1st 2002, the domestic currencies served as substitute vehicles for the Euro. Starting from January 1st 2002 countries phased out domestic currencies in favor of the Euro. Since July 1st 2002 all countries now use the same currency the Euro and all domestic currencies have ceased to exist.

III. EUROPEAN MONETARY UNION

- The 12 countries that joined the EMU have chosen to not only adopt the Euro but they have also chosen to cede monetary policy decisions to a newly created central bank, the European Central Bank (ECB).
- Since Jan 1st 1999, monetary policy making decisions have been vested in the ECB. The ECB together with the existing member central banks form a system known as the Eurosystem. The member central banks will take on a role similar to that played by the regional Federal Reserve Banks in the U.S. Federal Reserve System. They are a little more powerful in that they retain the power to regulate banks in the respective countries.
- The structure of the ECSB has been closely modeled on the Fed and the Bundesbank. Monetary policy decisions are made by the Governing Council of the European Central Bank: an entity that mirrors the role of the FOMC in the United States.
- The ECB is headquartered in Frankfurt and the first head of the ECB was a Dutchman named Wim Duisenberg. The current head of the ECB is a Frenchman named Jean-Claude Trichet.

The Special Role of the ECB

- The ECB has to be a central bank for ALL of its member countries: its policy instruments will be EMU wide and not relate to a particular country. So the ECB will not worry about the interest rate in Germany or the interest rate in France but instead worry about changing Euro wide interest rates in setting monetary policy. The EMU-wide interest rate will be influenced by the buying and selling of Euros in open market operations.
- How should the ECB incorporate the economic conditions of the EMU member countries in setting policy decisions? Economists have suggested using weights to factor each country's macroeconomic conditions into the decision making process.
- So the ECB will worry about EMU wide inflation and EMU wide GDP growth for example. Each country's contribution to EMU-wide GDP or EMU-wide inflation may be given by a set of weights according to the relative size of consumption in the economy that are as follows:

  1. Germany 29.9%
  2. France 20.5%
  3. Italy 19.2%
  4. Spain 10.9%
  5. Netherlands 5.4%
  6. Belgium 3.3%
  7. Austria 3.2%
  8. Greece 2.6%
  9. Portugal 2.1%
  10. Finland 1.6%
  11. Ireland 1.3%
  12. Luxembourg 0.3%

- In addition to these features, the ECB has been given an explicit mandate to fight inflation and its independence from political interference is patterned once again after the Bundesbank and the Fed.
- In keeping with the state of the art macroeconomic research findings, attempts have been made to be as transparent as possible in setting monetary policy by releasing the minutes of monetary policy decision making meetings and through frequent press updates.
- Finally, the ECB's mandate is to maintain price stability - defined as an inflation rate of $<$ 2%. The ECB's mandate does not require that it maintain any particular value for the Euro vis--vis other currencies like the dollar. Even though there may be reasons why the ECB pays attention to the $/Euro exchange rate, it is not mandated to maintain exchange rate stability: the euro is free to fluctuate.

IV. ADVANTAGES OF EMU

1. Greater exchange rate stability

- Not only does the EMU eliminate the need for speculation about realignments of the European countries' currencies, it provides countries with the most stable exchange rate of them all: the same currency.

2. Better monetary policy for countries other than Germany

   - If the European Central Bank does its job as a bank with a true European focus, then smaller countries get to combine the exchange rate stability for intra-European trade with some monetary policy flexibility: a rare combination of the virtues of a fixed and a flexible exchange rate system.
   - The ECB will be way better than the old ERM because the policymaker is now no longer fixated on one country.
   - The attention devoted to setting up a clear inflation fighting mandate and granting greater independence from political interference for the ECB would mean that monetary policy for many countries like Italy would now be better than was possible under flexible exchange rates.
   - In other words, a country like Italy would neither have to rely on a Bundesbank that cared only about Germany nor have to deal with their own irresponsible monetary policy making

3. Elimination of transaction costs.

   - Travel across Europe as well as trade in goods and services will be enhanced by the common currency. Typically, when converting one country to another, all but the largest of transactions will involve a fee of about 1-2% of the transaction. The old urban legend of starting out with $100 and being left with $40 after exchanging that money into different currencies as you passed through various countries no longer applies.
   - Traders no longer have to hedge their currency obligations, and do not have to concern themselves with the prospect of a realignment of the exchange rate bands as they did under the old ERM.

4. Eliminate price discrimination between markets

   - The common currency will mean that arbitragers will be more easily able to act to impose some form of purchasing power parity (absolute or relative) across countries. Therefore, firms will be less able to charge different prices across countries and governments will be less able to use hidden trade barriers to restrict imports.

V. DISADVANTAGES OF EMU

1. Less autonomous monetary policy for Germany compared to the old ERM.

   - If the European Central Bank does its job as a bank with a true European focus, then Germany should only count for about 30% of its monetary policy decisions. So the ECB will be less likely to use expansionary monetary policy in response to a German specific negative shock than under the old ERM

2. Lack of voice for smaller countries

    - Under ERM II, smaller countries like Ireland and Austria may have had a more autonomous monetary policy than they would under EMU. Since the bands were 15% wide on either side, the system would have function as a de facto flexible exchange rate system with more monetary autonomy.

3. Difficulty of revoking ones membership in the EMU

    - Under the old system, it was possible for a country to pull out if its interest was not being served by remaining within the aegis of a fixed exchange rate system (ex. Britain in 1992). Under EMU, if say Ireland decides to pull out, the adoption of a common currency may make it extremely difficult for it to do so.

4. The potential for political infighting compromising the integrity of the ECB.

    - The Bundesbank had a proven track record when it comes to fighting inflation. The ECB has all the right institutional structure in place to develop a similar track record but there is potential for excessive influencing of monetary policy decisions to suit one country's economic conditions even if other countries are made worse off by such a change.

VI. EXPANDING THE MEMBERSHIP OF THE EMU

- Another interesting issue becomes the expansion of EMU beyond the 12 member countries. Specifically, the countries of most interest are the other 3 EU countries: the United Kingdom, Denmark and Sweden and down the road, the 10 new EU members: Poland, Hungary, the Czech Republic, Slovakia, Slovenia, Latvia, Lithuania, Estonia, Cyprus, Malta.
- Interestingly enough there are differences between the circumstances of these 3 countries: Denmark and the U.K were ERM members who have chosen to stay outside of the EMU, perhaps wary of repeating the economic woes of the last ERM experiment. Denmark, however, has decided to commit to staying within the 15% band ERM II.
- Sweden, never really joined the ERM in the first place, and has also expressed a reluctance to give up monetary autonomy and their national currency and have chosen to stay outside of EMU as well.
- Whether these countries choose to join remains up in the air. England, Sweden and Denmark seem to be taking a wait and see approach, preferring to enjoy the greater exchange and monetary flexibility to the benefits afforded by a common currency.
- Even more interesting is the potential of the 10 new EU members eventually deciding to join the EMU as well.
- What then does the future hold for the EMU? Contrary to conventional wisdom, the EMU did make a fairly smooth beginning and a fairly orderly transition. It has run fairly smoothly over the first 4 years although cracks have started to appear with the sluggish economies of Germany and France.

- There has already been a mini-crisis in the second year of the EMU when the Euro slumped by 30% and the ECB resorted to optimistic interventions in the foreign exchange market to try and stabilize the currency. This has of course been completely transformed in recent months by the weaknesses of the dollar.
- Does more trouble lie ahead? In order to answer this question, and also discuss what lessons other regions can draw from the EMU experience, we will focus on an area of research known as "Optimal Currency Areas". This was Robert Mundell's second major contribution to economics and is basically a line of thinking that discusses the conditions under which a group of countries should adopt a common currency.
- We will then examine if these conditions are satisfied by the EMU (and by EMU expansion) to see if we can draw any conclusions about the likelihood of continued future success.