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Monetary cooperation and monetary policy in the EU

The theory of Optimum Currency Areas; the beginnings of European monetary integration

Lecture 1

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The theory of Optimum Currency Areas; the beginnings of European monetary integration

Lecture 1

In this lecture you will learn about:

- The Optimum Currency Area (OCA) theory
- The beginnings of European monetary integration
- The Werner Report
- The first elements of European monetary integration (the Snake, the EMCF, the ECU)
- The European Monetary System (EMS)

The Optimum Currency Area (OCA) theory

The Eurozone within the European Union forms a monetary union. As such, it can be compared to the theoretical implications of **Optimum Currency Areas** (OCAs) described by **Robert A. Mundell**, Nobel Memorial Prize-winning Canadian economist in a **1961** scientific journal article.

According to the **OCA theory**, there are **four conjunctive conditions** for a successful monetary union:

1. Free movement of labour
2. Flexibility (of capital movements, prices and wages)
3. The existence of an automated transfer system to spread risks
4. Synchronised business cycles across the currency area

The beginnings of European monetary integration

The **European Economic Community (EEC)**, predecessor of the European Union (EU) was formed by the **Treaty of Rome** on **25 March 1957** by the following six member states: (West) Germany, France, Italy, Belgium, the Netherlands and Luxembourg. The Treaty of Rome envisaged a common market in which the both outputs (goods and services) and the inputs (capital and labour) of production can move freely. However, **the Treaty did not contain any provisions on monetary cooperation or integration**.

At that time, the **Bretton Woods System** was operating. The Bretton Woods Agreement and System created a collective international currency exchange regime that lasted from 1944 to the early 1970s. The Bretton Woods System required a **currency peg to the US dollar** which was in turn pegged to the price of gold. The system collapsed in the early 1970s when the **gold reserves of the United States no longer covered the amount of USD in circulation in the global economy** (i.e. the exponential boost in post-World War II international trade surpassed the expectations).

In the 1960s, the EEC was far from fulfilling the OCA conditions. As a matter of fact:

1. Theoretically and at the level of legislation, there has been **free movement of labour** across the EEC/EU since its foundation in 1957 but, in reality, cross-border movement of labour is **obstructed by a number of 'natural' factors**, e.g. linguistic differences, cultural differences, differences in the labour markets of the member states etc.
2. **Capital can indeed move freely** across the EU and the Eurozone but this was not fully achieved prior to the 1990s. However, *prices and wages are far from flexible*. Nevertheless, integration and the introduction of the euro in 1999 has resulted in considerable and continuous price convergence in the EU and the Eurozone since then.
3. Before the Eurozone crisis of 2010-2013, **there was practically no automated risk-spreading mechanism** in the EU/Eurozone. The EU budget, accounting for ca. 1% of the EU's total GDP is insufficient to serve as such a system. During the management of the Eurozone crisis, some measures at EU level (i.e. establishing the economic governance and the banking union) were targeting this very goal.
4. **Synchronised business cycles** are important in a monetary union as the counter-cyclical common monetary policy can only be effective this way. Unfortunately, as we could see during the Eurozone crisis, **member states have been in rather different phases of the business cycle**.

Nevertheless, the **EEC member states started their discussions on how to exclude the USD from the within-Community trade** which, in fact, also grew exponentially in the first period of European integration, doubling in volume in every three years or so. Especially **Charles de Gaulle**, at-that-time President of France was strongly against a USD-based intra-Community trade. Instead, he emphasised **national monetary autonomy** that should be preserved in a European monetary system.

The Committee of the Governors

The Committee of Governors ("CoG", or "Committee"), was established in 1964 to promote cooperation between the central banks of the Member States, by holding consultations and exchanging information on monetary policies and relevant measures, with a particular focus on the credit, and money and exchange markets. The Committee usually met in Basel at the Bank for International Settlements (BIS), which provided logistical and secretarial support. In January 1994, the Committee of Governors was replaced by the European Monetary Institute (EMI).

The forum for this discussion was the first informal meetings of the central bank governors of the EEC member states. Thus the **Committee of the Governors (CoG) was formed in 1964**, at that time as an **informal body**.

In **1969**, the **EEC members** held their **Summit** in **The Hague**, Netherlands, **deciding to take steps of monetary integration** and, eventually, **arriving at a monetary union** in the EEC in the future.

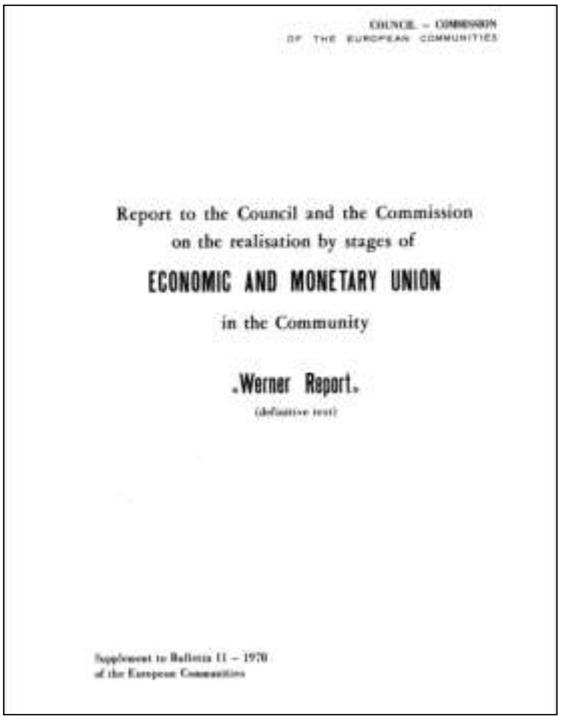
Monetary integration	Monetary union
• narrowing exchange rates of participating currencies • monetary policy coordination between national central banks	• irrevocable fixing of exchange rates and introduction of a single currency • single monetary policy conducted by a common central bank

The Werner Report

Upon The Hague Summit, Luxembourgian Prime Minister, **Pierre Werner** was assigned the task to set up a **Committee** and draw up the **plans of monetary integration** in the EEC. As a Luxembourger politician, Werner by then had vast experience and abilities of compromise in international affairs. Also, Luxembourg as a country had been experienced in international monetary integration: Luxembourg did not have its own central bank but had been in a monetary union with Belgium since 1921.

Belgium–Luxembourg Economic Union

The Belgium–Luxembourg Economic Union (BLEU) was created by a treaty, signed on 25 July 1921, despite a referendum against such a proposal, between Belgium and Luxembourg, and came into effect upon ratification by the Luxembourg Chamber of Deputies on 22 December 1922. Under the terms of the treaty, the economic frontier was lifted and the Belgian franc and Luxembourg franc were set at a fixed parity (though revised in 1935 and 1944) establishing a monetary union, which existed until the introduction of the euro. The original treaty lasted for fifty years, expiring in 1972; this was extended for ten years in 1982 and again in 1992.



COUNCIL – COMMISSION
OF THE EUROPEAN COMMUNITIES

Report to the Council and the Commission
on the realisation by stages of
ECONOMIC AND MONETARY UNION
in the Community

„Werner Report"
(definitive text)

Supplement to Bulletin 11 – 1970
of the European Communities

The **Werner Report**, presented to the Council in **1970**, suggested that an **Economic and Monetary Union (EMU)** should be introduced in the EEC **in stages**.

Composition of the Werner Group	
P. Werner	Prime Minister of Luxembourg
H. Ansiaux	President of the Committee of Governors of the Central Banks
G. Brouwers	Chairman of the Conjunctural Policy Committee
B. Clappier	Chairman of the Monetary Committee
U. Mosca	Director General of Economic and Financial Affairs of the EECJ.
B. Schöllhorn	Chairman of the Medium-Term Economic Policy Committee
G. Stammati	Chairman of the Budgetary Policy Committee
Secretary:	G. Morelli

Steps to be taken in the stages of **introducing the EMU** according to the **Werner Report**:

1. **First stage** (3 years):
    - reinforced economic policy coordination to ensure the free circulation of goods, services, capital and labour;
    - frequent exchange of information on economic policies
    - set up the fundamental guidelines of the common monetary policy
    - institutional development
2. **Second stage** (impossible to define its time period in advance):
    - laying down global economic guidelines
    - coordination of short-term economic policies by monetary and credit measures
    - budget and fiscal measures

- adoption of Community policies in the matter of structures
- integration of financial markets
- progressive elimination of exchange rate fluctuations between Community currencies

3. **Final stage**:
   - irrevocable fixing of the exchange rates
   - introduction of the common currency

As widely known, the **Werner Plan was eventually not realised**. The collapse of the Bretton Woods System, the oil price shocks of 1971 and 1973, and the subsequent recession, industrial decline, unemployment and inflation in Western Europe swiped the plan of the EMU off the table. Nevertheless, **the Werner Report is significant in two respects**:

1. The eventually implemented **Delors Plan largely relied on** the investigations, findings and considerations of **the Werner Committee**.
2. **Monetary integration did start in Europe in the 1970s**: the Snake, the EMCF and the ECU were introduced in the 1970s, and the EMS Treaty was signed in 1979.

This way the trade integration among the EEC members and the collapse of the Bretton Woods system can be considered as triggers of the first steps towards the EMU.

The Paris Summit

In October **1972**, the Heads of States and Governments of the member states of the EEC gathered in **Paris**. It was a **Summit of crucial importance in several aspects**. In terms of the **EMU**, the following are relevant on behalf of the member states:

- commitment to set up a EMCF;
- commitment to promote the process of EMU into the second stage of the Werner Plan in 1994
- commitment to establish the EMU by the end of the decade (1970s);
- commitment to convert the EEC into European Union, also by the end of the decade (1970s).

The first elements of European monetary integration

Even though the Werner Plan was not implemented, monetary integration was started in the EEC in the 1970s. Its most important elements initiated at that time are: the so-called **"Snake"** (i.e. the gradual narrowing of exchange rates), the **European Monetary Cooperation Fund**, the **European Currency Unit** and then, in 1979, the signature of the agreement establishing the **European Monetary System**.

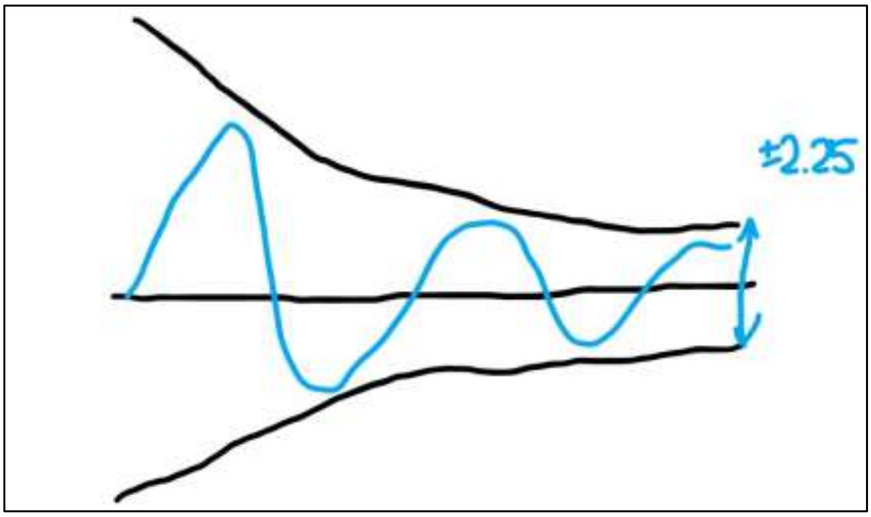
The role of the **Bank for International Settlements (BIS)** in European monetary integration

From 1964 until its dissolution at the end of 1993, the **Committee of Governors met at the BIS**, which also provided its secretariat. The **European Monetary Cooperation Fund (1973)** and the **European Monetary System (1979) were operated from Basel**, with the BIS providing the necessary technical support. **In 1988-89 the Committee** for the Study of Economic and Monetary Union, **chaired by** European Commission President **Jacques Delors**, **convened in Basel** and laid the technical groundwork for the European Council's decision to move towards full European monetary union, as approved by the 1992 Treaty of Maastricht.

The Snake

The “snake in the tunnel” was the **first attempt at European monetary cooperation** in the 1970s, aiming at **limiting fluctuations between different European currencies**. It was an attempt at creating a **single currency band** for the European Economic Community (EEC), essentially **pegging all the EEC currencies** to one another.

Snake in the tunnel



The Bilateral Parity Grid

A grid (known as the Parity Grid) of bilateral rates in the European exchange rate system was calculated on the basis of the central rates (expressed in ECUs from 1979 onwards), and currency fluctuations had to be contained within a margin of 2.25% on either side of the bilateral rates (with the exception of the Italian lira, the Spanish peseta, the Portuguese escudo and the pound sterling, which were allowed to fluctuate by ±6%).

Determined intervention and loan arrangements protected the participating currencies from greater exchange rate fluctuations.

European currency rates, 1972-1999, 1972=100, DEM/ECU=100

The **European Monetary System followed the "snake"** as a system for monetary coordination in the EEC.

The EMCF

At the Paris Summit of 1972, among others, the Member States also decided to promote the establishment of a European Monetary Cooperation Fund or European Monetary Fund, in line with the recommendations of the Werner Report.

The **European Monetary Cooperation Fund (EMCF)** was established in **1973** to increase cooperation between Member States working towards the EMU. It operated from Basel, at the Bank for International Settlements (BIS).

- The EMCF's **primary aim** was to **ensure the proper functioning of the progressive narrowing of the fluctuation margins** between the participating currencies.
- It also **monitored interventions on the exchange markets** in Community currencies.
- Finally, it was **responsible for the administration of short-term financing and for settlements between central banks**, leading to a concerted policy on reserves.

From 1979, with the introduction of the EMS and the ECU, **it carried out all tasks related to the creation, use and remuneration of ECUs**.

The EMCF was **dissolved on 1 January 1994** when its **roles were taken over by the European Monetary Institute (EMI)**.

The ECU

The **European Currency Unit (ECU)** was a **basket of the currencies of the European Community member states**, used as the **unit of account** of the European Community before being **replaced by the euro on 1 January 1999, at 1:1 parity**.

Weights of participating currencies in the ECU basket in 1979 (%)*	
Belgium	7.34
Denmark	3.29
Germany	22.03
France	22.03
Ireland	1.27
Italy	14.67
Netherlands	7.34
United Kingdom	22.03

* Luxembourg was in a monetary union with Belgium.

The European Monetary System was built on the concept of **stable but adjustable exchange rates** defined according to the newly created **European Currency Unit (ECU) – a currency basket based on a weighted average of EMS currencies**. Unlike the euro, the ECU was not a real currency, only an **electronic unit of account** without any official coins or notes that could be used for cash transactions.

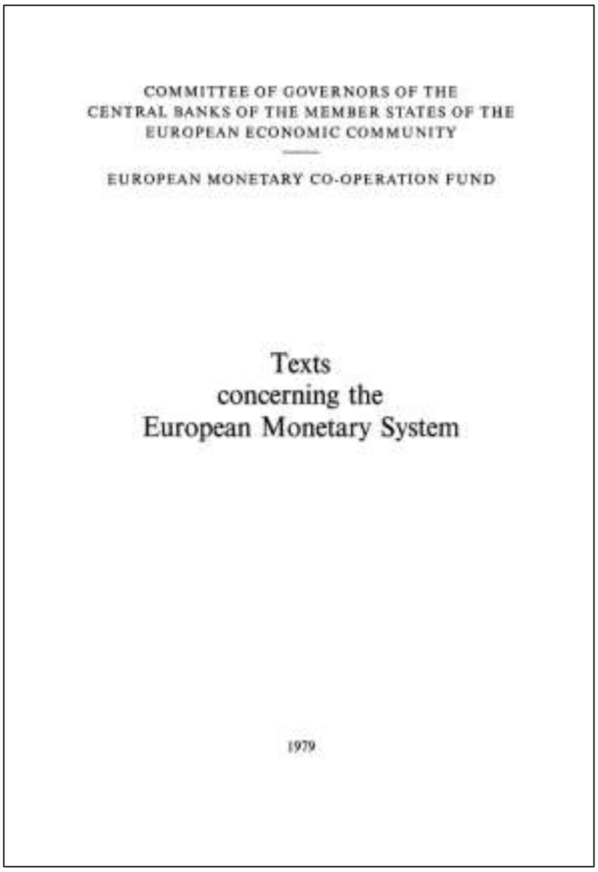
The European Monetary System (EMS)

The agreement establishing the **European Monetary System (EMS)** was signed at the BIS in Basel, on 13 March **1979**.

The EMS was eventually an **exchange rate regime** set up in 1979 (and ended in 1999) to foster **closer monetary policy co-operation** between the central banks of the Member States of the European Economic Community (EEC). The **objective** of the EMS was to **promote monetary stability in Europe**.

Within the EMS, currency fluctuations were controlled through the **Exchange Rate Mechanism (ERM)**.

The EMS was a radical new departure because exchange rates could only be changed by mutual agreement between participating Member States and the European Commission – an **unprecedented pooling of monetary sovereignty**. It was replaced by ERM II (exchange rate mechanism II) at the start of Stage Three of Economic and Monetary Union on 1 January 1999 when the single currency was launched.

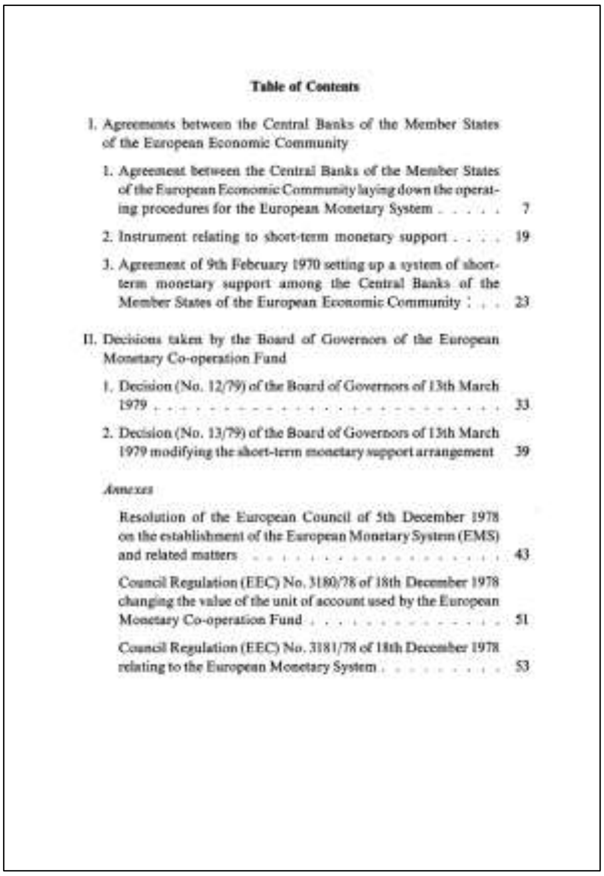


COMMITTEE OF GOVERNORS OF THE
CENTRAL BANKS OF THE MEMBER STATES OF THE
EUROPEAN ECONOMIC COMMUNITY

EUROPEAN MONETARY CO-OPERATION FUND

Texts
concerning the
European Monetary System

1979



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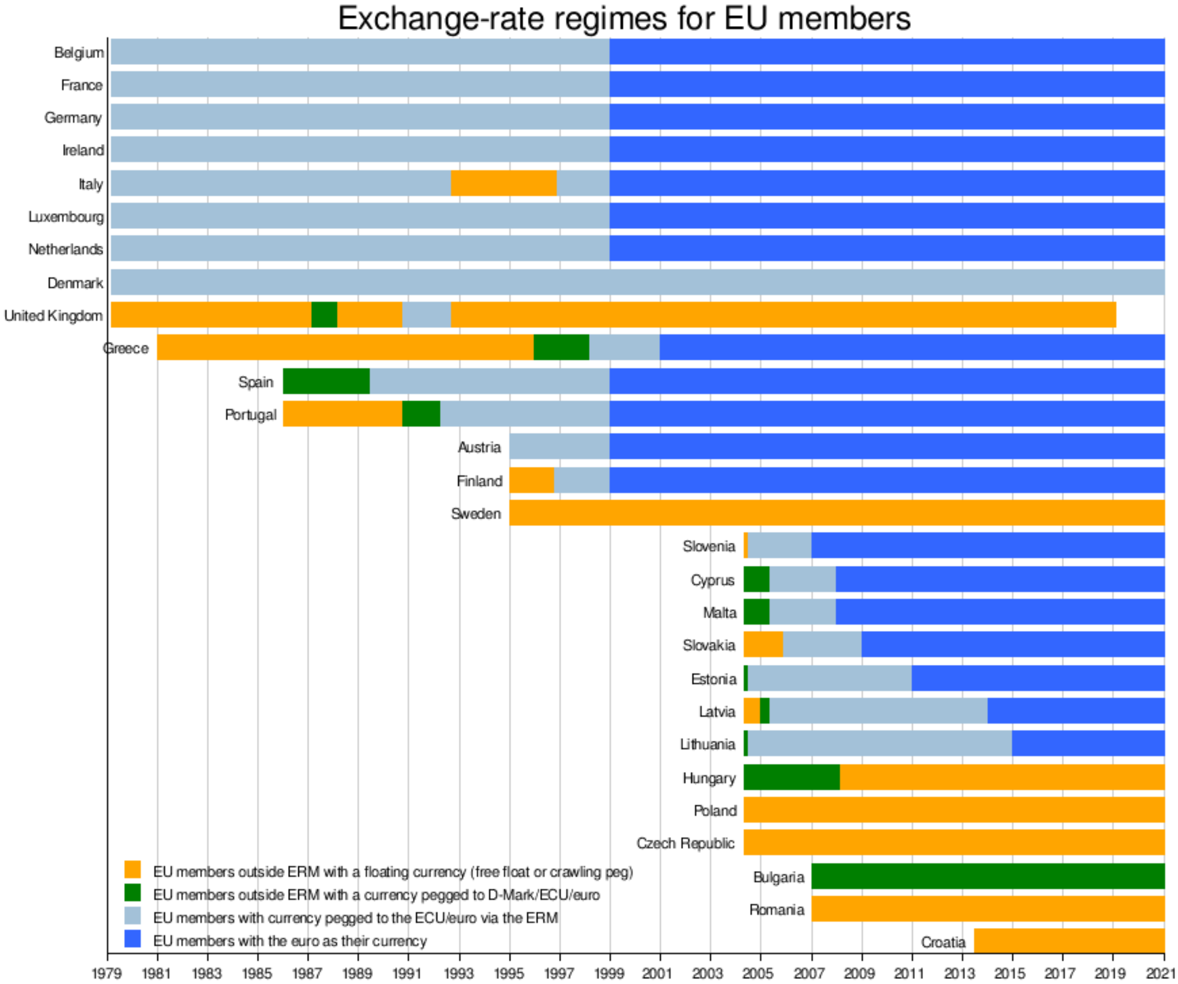
The Council Resolution of 5 December 1978 foreseeing the establishment of the EMS regarded **regional and structural policies** as crucial to the success of the EMU. This is relevant as the narrowing and, eventually, disappearing fluctuations among the participating currencies make adjustment through monetary measures first difficult, and then (with the monetary union) impossible. Therefore regional and structural disparities have to be addressed by Community policies and the common budget.



Questions for self-study

1. Who laid down the theory of Optimum Currency Areas (OCA) and when?
2. According to the theory of Optimum Currency Areas, which are the four criteria of a successful monetary union?
3. Was the objective of the introduction of a common currency included in the Treaty of Rome?
4. Which was the central currency of the Bretton Woods system?
5. In the 1960s, which European politician claimed for 'national monetary autonomy'? What nationality was he?
6. In what year did the European summit in The Hague take place? In what respect is that summit relevant in the history of EEMU?
7. What nationality was Pierre Werner? Why is that important?
8. When was the Werner Plan introduced to the European Council?
9. In what year was the EMCF set up?
10. What is the significance of the 1972 Paris Summit in relation to the EEMU?
11. When was the EMS eventually launched?

12. The EMS regulation regarded regional and structural policies as crucial to the success of the EMU. How are these areas of European integration related to each other?
13. What are the consequences and implications of growing interdependency of countries as European integration is deepening?

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