The European Monetary Union (EMU)

Adriana Veliz and Carrie Hellem
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“The Economic and Monetary Union of the European Union”

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  - Before, each nation had their own currency.
  - Creation of the EMU resulted in adoption of the euro.
    - With the exception of Denmark and the U.K.
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A: Pound (before Brexit) and the Danish Krone
History

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      - “Where are the European currency, the European stamp that we need?”
- However, this idea became derailed due to the Wall Street crash of 1929, which lead to the Great Depression.
- Europe became even more politically split
The Schuman Declaration

- Proposed by Robert Schuman in May 1950, who was the French Foreign Minister at the time.
  - There was a need post-WWII to prevent future conflicts in Europe.
- Idea was to unify European steel and coal production and thus materially prevent wars between European nations. Such a union was thereby created through the Treaty of Paris in 1951, which would become known as the European Coal and Steel Community (ECSC).
  - Through merging economic interests, the overall economy and standard of living in European nations would improve. Other countries were welcome to join the ECSC, as the goal was to unite Europe.
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- Foundation for the creation of the EU.
The Schuman Declaration

"The pooling of coal and steel production... will change the destinies of those regions which have long been devoted to the manufacture of munitions of war, of which they have been the most constant victims."
Werner Plan (1970)

- In 1968 Pierre Werner, the prime minister of Luxembourg, proposed a single currency.
- This led to the Werner Plan, in which the Heads of State and Government of the European Community agreed to prepare a plan for economic and monetary union.
- It called for gradual, institutional reform leading to the permanent fixing of exchange rates and the adoption of a single currency in the EU within the next ten years.
- The plan was never implemented; the U.S. devalued the dollar a year later and an oil crisis followed.
- France retired its support after a France-US meeting in the Azores at the end of 1971.
“The Currency Snake”

Instead of a common currency, some European nations introduced limits on exchange rate fluctuations against a number of European currencies and against the U.S. Dollar.
European Monetary System (EMS)

- Founded in 1979 to stabilize foreign exchange and prevent large fluctuations in inflation.
- European Currency Unit (ECU)
- Agreed to keep currency within a fluctuation band of ±2.25%
- Between its introduction and 1987, there were 37 currency realignments to raise values of stronger currencies and lower values of weaker ones.
Maastricht Treaty

• Maastricht Treaty began implementation of the euro in 1992
  ○ Creation of the EMU resulted in adoption of the euro throughout participating nations.
  ○ Established criteria for joining the EMU
    ■ low inflation
    ■ interest rate similar to that of low inflation countries
    ■ stability of exchange rate
    ■ low public deficit
    ■ low public debt
• In 1998, EU leaders met in Brussels to decide which states had reached the criteria and could join the EMU.
Establishing the Euro

- The European Central Bank was established on June 1, 1998
  - Joined national central banks of the member states of the EU; ECB along with national central banks formed the European System of Central Banks.

- Euro officially established on December 31, 1998
  - Exchange rates of 11 participating nations at the time became fixed
Transitioning into the Euro

- Euros are put into circulation in 2002, while existing national currencies started to be withdrawn.
  - National currencies were to be fully withdrawn before March 2002
- Time between the establishment of the Euro and its circulation was used to print 13 billion banknotes and 52 billion coins.
Summary: 3 Stages of the EMU

I. 1990 - 1993
   A. Focused on economic convergence
   B. Cooperation between national central banks
   C. Liberalization of the free flow of capital

II. 1994 - December 1998
    A. Legislation that would lead up to the EMU is made
    B. ECB is created

III. 1999 - now
    A. Euro is now established as a currency
    B. Participating nations (the eurozone) gain fixed exchange rates, becoming subdivisions of the euro. Currently, 17/27 EU nations belong to the eurozone.
Prof. Paul de Grauwe: Design Failures

I. “Boom and Bust” Dynamics

A. EMU creates centralized control over eurozone monetary policy, but does not have a direct influence on endogenous macroeconomic factors that would create “booms” or “busts” in the capitalist economies of individual eurozone nations.

B. Fixed interest rate across the eurozone
   1. Differences in underlying macroeconomic conditions become intensified
   2. “Busts” will have a stronger impact; stronger recessions
      a) The EMU effectively worsens national recessions in the eurozone
II. Lack of Stabilizers

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   2. Typically a central bank, national lenders of last resort removed in EMU.
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B. Government bond market in eurozone is thus left very fragile.
   1. Bonds not guaranteed to be paid at maturity
      a) Possibility that a eurozone member state could not have enough cash to pay out bondholders.
   2. This leads to a heightened potential for bank runs. (beliefs about beliefs)
      a) If depositors believe that an institution could become insolvent they will all withdraw, or in this case sell their bonds, reducing national liquidity.
Compare with the United States Economy

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- The Federal Reserve will provide liquidity in times of crisis, as would the central banks of stand-alone nations outside the eurozone.
ESCB and Eurosystem

European System of Central Banks (ESCB): composed of the European Central Bank (ECB) and the national central banks of the 27 EU Member States (whether they have adopted the euro or not)

Eurosysteem: composed of the European Central Bank (ECB) and the national central banks of the 17 countries that have adopted the euro.
## Organization of the ESCB

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<tr>
<th>Governing Council</th>
<th>Executive Board</th>
<th>General Council</th>
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<tr>
<td>● Formulates the monetary policy for the euro area</td>
<td>● Implements monetary policy for the euro area in accordance with the guidelines specified and decisions of the Governing Council</td>
<td>● Includes the governors of the NCBs of all EU countries, whether or not they have joined the euro</td>
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<tr>
<td>● Consists of the six members of the Executive Board, plus the governors of the national central banks of all euro area countries</td>
<td>● In doing so, it gives the necessary instructions to the euro area national central banks (NCBs)</td>
<td>● Prepares the irrevocable fixing of the exchange rates of the EU member states’ currencies which don’t participate yet in the euro</td>
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<td>● In most cases, decisions made by simple majority</td>
<td></td>
<td>● Exists as long as there is are EU member states which haven’t adopted the Euro</td>
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Monetary Policy under the EMU

- Broad objectives established in the Maastricht Treaty
- Main objective: to maintain “price stability”
- The 2% inflation target is considered optimal for promoting growth and employment
Monetary policy instruments

- Main instrument: open market operations
- Main open market operation: “repo” ("repurchase")
  - The difference (in relative terms) between the initial price and the repurchasing price corresponds to the repo interest rate
  - The repo interest rate has in turn an impact on the interest rate at which commercial banks lend to consumers or firms
Exchange rate policy

- The euro fluctuates with respect to the most important currencies
  - The external value of the euro is determined by financial markets, so the exchange rate cannot be an instrument of economic policy
- However, given that other exchange rate regimes are possible, the Maastricht Treaty specifies who makes decisions for this type of exchange rate regimes
  - According to the treaty, the exchange rate policy of the euro area is defined by the ESCB and the Ecofin (Council of Finance and Economics ministers)
Fiscal policy and its coordination mechanisms

- Each national government chooses and applies its own fiscal policy
- At the same time:
  - Fiscal policies are coordinated within the Ecofin
  - The European Commission makes yearly recommendations on the main orientations of the policies
  - There is a multilateral surveillance by all the countries of the fiscal policy of each country
Growth and Stability Pact

- Specifies the procedures for the surveillance and the sanctions the Member States may have to face if they incur deficits that are considered “excessive”
- The objective is to avoid coordination problems in the implementation of national fiscal policies
- Each euro area country presents a future plan on its intended fiscal policy
- Budget deficits shouldn’t exceed 3% of the country’s GDP. What happens if it does?
Excessive Deficit Procedure

- Action launched by the European Commission against any EU member state that exceeds the budgetary deficit ceiling
- If the deficit is declared “excessive,” Ecofin provides recommendations to the country’s government on how to reduce the deficit and gives a deadline for the elimination of the excessive debt
- If the excessive deficit is not eliminated in time, Ecofin decides on the imposition of sanctions to the country
Ongoing and Previous Excessive Deficit Procedures

2 remain, down from 24 in 2011
Treaty on Stability, Coordination, and Governance

- New mechanism for the coordination of fiscal policies, approved in December 2011
- Signed in March 2012 by all EU countries except the Czech Republic and the UK
What’s New?

- National budgets have to be in balance or surplus: achieved if the annual structural government deficit does not exceed 0.5% of nominal GDP.
- Balanced budget rule has been incorporated in the national legal systems
- “Excessive deficit procedure” to be more automatic
- Euro area member states to hold a meeting at least twice a year, “Euro Summit”
Optimal Currency Area Theory
Theory by Robert Mundell (1961)

- According to this theory, a group of countries (or regions) constitute an optimal currency area (OCA) if:
  - The shocks experienced by these economies are symmetric and/or
  - There are alternative adjustment mechanisms (i.e. other than the exchange rate) when shocks are asymmetric
Symmetric Shocks

A group of countries are said to face symmetric shocks if they face shocks that are similar in their extent and nature.

Shocks are more likely to be symmetric across countries if:

- The productive structures of the countries are similar
- The countries have similar degrees of openness
- There is not too much specialization across countries
Example of an Asymmetric Shock

Consider a case of a country specialized in the production of one good.

- Assume Syldavia exports wood to others in the area
- Assume that the Syldavian labor market is characterized by the existence of a minimum wage
- We will compare the impact of a negative shock on the demand for wood when Syldavia belongs to the euro area and when it remains out of it
With the euro
Without the euro
Alternative Adjustment mechanisms

- Flexibility of markets for inputs
- Labor migrations across regions or countries
- Redistribution towards the country experiencing the shock
Advantages of the EMU

- Will the euro become a vehicle currency?
- Reduction in transaction costs
- Micro efficiency gains
- Political Stability
- Euro area as a whole is much bigger and much more closed
Timeline of the Greek Debt Crisis

2001 - Greece misrepresented its finances to join the eurozone

2009 - Greece announces it had been understating its deficit figures for years

   Announces its budget deficit would be 12.9% of GDP (3x the EU’s limit)
2010 - First bailout from IMF and EU in exchange for austerity measures

The ECB launches the Securities Market Program.

2012- Finance ministers approve a second EU-IMF bailout for Greece

ECB announces an open-ended program to buy the government bonds of struggling eurozone states on the secondary market

Eurozone revises Greek bailout
2013- Greece’s Parliament approves unpopular new austerity measures

2014- Greece returns to international financial markets with its first issues of Eurobonds

2015- Greek bailout expires

   Greek Parliament supports a new deal
   Third Bailout approved

2017- Greece’s Creditors Tussle Over Debt Relief
Questions?
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