# European Monetary Union

When the Treaty of Rome was signed in 1957, its six original signatories - France, Italy, West-Germany and the Benelux countries - aimed to lay the foundations of an ever closer union amongst the people of Europe. A Monetary Committee was set up in 1958 to consider the possibility of a common monetary policy. Walter Hallstein, the first EC president, held the view that a common monetary policy aimed at achieving stability would be more than a touchstone for the Community; it would be a fundamental requirement.

Today, more than 30 years after the foundation of the EC, neither complete monetary union nor a single monetary policy for the Community have been achieved. Britain has yet to join the Exchange Rate Mechanism of the EC, and remains very sceptical about any moves leading towards monetary union.

This essay aims to analyse and assess the consequences of European Monetary Union (EMU) as implied by the recent Delors Report. Firstly, the definition of monetary union will be examined. Having considered the benefits and costs associated with monetary integration, I propose to evaluate what is the optimal level of monetary integration for the community.

According to the Delors Report, EMU will involve the operation of a single market, irrevocably fixed exchange rates and the co-ordination of macro-policy. EMU will necessitate both positive integration (for example the establishment of common policies, the the creation of new institutions such as a European Central Bank System, etc.) and negative integration (for example the removal of barriers to the movement of goods, labour and capital).

This is not the Community's first attempt at monetary union. Following the Werner Plan in the late 'sixties, the EC decided to set 1980 as the date for achieving monetary union. The *snake* system was adopted in 1970, which allowed EC currencies to fluctuate within 2.5% margins. The snake was replaced by the European Monetary System (EMS) in March 1979 in a period characterized by high inflation and unemployment. The objective of the EMS was to create a zone of internal and external monetary stability in Europe that would better withstand the effects of a highly unstable and weak US dollar. The EMS involves the pegging of currencies to the Deutschmark. The Deutsche Bundesbank was somewhat reluctant at first to allow the DM to be used as a reserve currency, for fear it would lead to inflationary pressures in the West-German economy. The European Currency Unit (ECU) was created at the same time as the EMS. It is composed of a fixed amount of European currencies, whose shares are proportional to GDP, trade performance and quotas. Although it has enjoyed moderate success with private investors and companies (the French civil engineering firm St. Gobain draws up its accounts in ECU's) its role as a numeraire in exchange rates has only been symbolic. Changes in bilateral exchange rates have been crucial in realignements.

The Delors Report proposes to achieve EMU in three stages. The first one is the initiation stage. It will involve a greater convergence of economic policies, full participation in the EMS of all member states, the complete liberalisation of capital and the removal of obstacles to the private use of the ECU. The second stage will consist of establishing a legal base for EMU. This phase will require amendments to the existing Treaty and the creation of a European Central Bank System. The third stage will bring about the irrevocable locking of exchange rates. Monetary policy will be handed over completely to the European Central Bank System (ECBS). Following this, the establishment of a single currency would be a mere formality.

The principal aim of EMU is to increase the scope and ambition of the Community. There are many benefits arising out of monetary union. Firstly, it will provide an effective means of controlling inflation, via a mechanism of interventionist policies directed by a ECBS. Secondly, stability in exchange rates would be guaranteed, which is an essential requirement for the existence of a genuine single market. The fixing of exchange rates can only be achieved once monetary stability has been achieved first. It is an evolutionary rather than a revolutionary process. Thirdly, monetary union will lead to economies of scale in the amount of reserve holdings actually held by central banks.

However, successful monetary union depends on several factors. EMU will rely heavily on a set of rules, but its proper functioning will depend primarily on the willingness of partner countries to satisfy the requirements underlying stable exchange rates, just as the EMS does today.

The realisation of EMU will also involve the transfer of monetary policy decisions from a national to a European level, where they will be cónducted by a non-elected body. This can be best achieved by a body free of political interference. The highly politicised EC has always tended to opt for averages and compromises. However, this will not work in the case of monetary policy. A European Central Bank must not foresake long term anti-inflationary policies for the temptation of election catching. As William McChesney Martin (former Chairman of the Fed.) put it: "The role of a Central Bank is to take away the punch-bowl just as the party gets going". In order to be efficient, the ECBS will need to have a monopoly on the creation of money. Otherwise, it would be a tiger without teeth.

Most European countries are somewhat sceptical about the creation of an ECBS. In order to be successful, it should lead to a situation in countries with stable currencies that they remain stable; for countries experiencing an eroding of their currency, it should lead to a situation of stabilisation.

Many countries are worried bout the loss of political autonomy implicit in EMU. The British argue that in order to achieve EMU, there is no need to surrender the amount of national sovereignty specified by the Delors Report. Another pretext for Britain not joining the EMS lies with the government's preoccupation with market forces rather than interventionist policies.

With EMU, seigniorage will no longer be available as a fiscal stabilisation tool. It involves the creation of money to erode debt. The loss of monetary independence will also have regional effects, which could be quite severe in the case of Ireland. The option of devaluation, which has positive output and employment effects under certain conditions will no longer be available to Ireland. It has been argued that such adverse regional effects could be cushioned by the establishment of budgetary mechanisms. However, there is no mention of such mechanisms in the Delors Report.

Monetary Union as defined in this essay, in my opinion, is highly desirable from an economic point of view, notably for its implications for stabilisation, low inflation and uniformity. However, there are transitional costs involved. They will tend to be short-term and will be largely borne by the private sector, whereas the benefits arising from monetary union will be spread more widely and will only materialise in the long- run. The success of EMU depends to a large extent on the willingness of governments to establish an ECBS, to foresake part of their political autonomy and not to counter Community monetary policy with national fiscal policy. There is no doubt that the outcome of EMU will determine the structure and future of the EC in times to come.

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