ulm university universität ulm

International Summer Program

June 26th to July 17th, 2006

Monetary Integration

By Matthias Kirbach

1. Introduction

- Monetary integration
- Theory of optimal currency areas
- Monetary integration after World War II
- European monetary integration

Types & Extent of Economic Integration

	FORMS OF INTEGRATION				
AREA OF INTEGRATION	**Free Trade Area**	**Customs Union**	**Common Market**	**Economic Union**	**Political Union**
Free Movement of Goods	■	■	■	■	■
Free Movement of Services	o	o	■	■	■
Movement of Capital					
– Free movement of Payment	■	■	■	■	■
– Free movement of Capital	o	o	■	■	■
Free Movements of Workers			■	■	■
Rights of Establishment			■	■	■
Common External Tariff		■	■	■	■
Competition policy		o	■	■	■
Co-ordination of Economic Policy					
– Monetary Policy			o	■	■
– Fiscal Policy			o	o	o
– Exchange Rate Policy			o	■	■

■ *Integration necessary* o *Integration useful due to economic inter-dependencies*

Monetary Convergence

Market

↓

Common

Financial Markets | Exchange Market

Efficiently working

- monetary markets
- capital markets
- competition on all financial markets

- common exchange rate system
- common exchange rate policy
- freedom of current and capital transactions (full convertibility)

Aims of a monetary union

- Intensification of economic and political integration
  - Representativeness of a common currency
  - Euro: counter balance to the US-$
  - Different political motivations
- Deepening of the economic integration ⇨ growth
- Declining of transaction costs
  - cost of information, uncertainty, exchange
- Increasing of economic stability
  - Improving monetary and fiscal credibility which leads to decreasing interests on capital
- European Monetary Union: emphasis on political intention

What are the advantages and disadvantages of a monetary union?

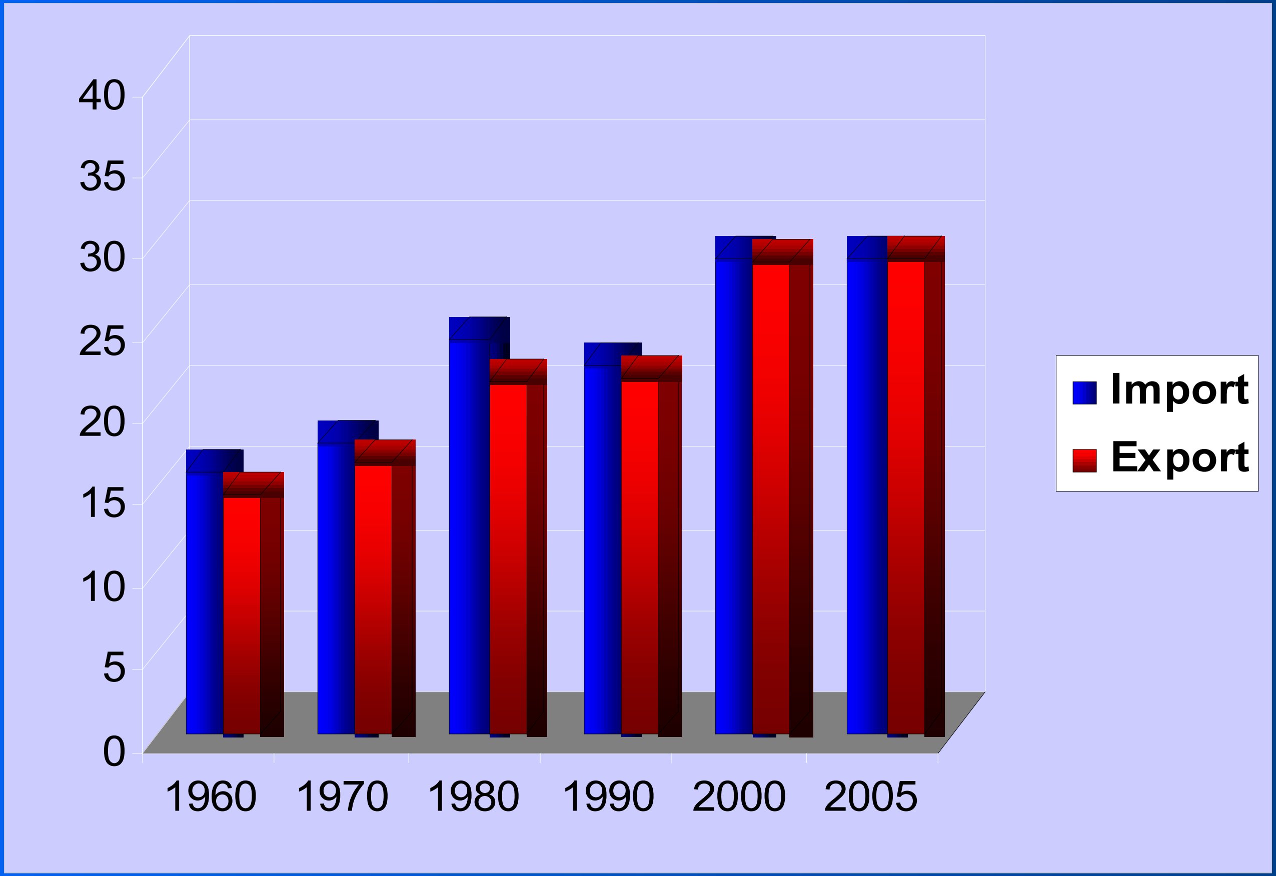
3. Theories of optimal currency areas

- Mundell:
  - Optimum currency areas are those within which people move easily
- McKinnon:
  - Countries which are very open to trade and trade heavily with each other form an optimum currency area
- Kenen:
  - Countries whose production and exports are widely diversified and of similar structure

Is Europe an optimal currency area?

Relative importance of total foreign trade

ulm university universität ulm



EU-15: Percentage share of goods imports and exports in total GDP of member states (current prices), 1960 - 2005

Source: European Commission, Statistical Annex of Economy, 2006, Tables 38,39, 42,43.

4. Monetary Integration

1. The Bretton Woods System
   - starting point 1944 – 1973
2. Transition period: exchange rate agreements
   - “snake in the tunnel” and EMS I, 1973 – 1998
3. European Economic and Monetary Union
   - the treaty of Maastricht 1991, the Euro 1999/ 2002 and the exchange rate mechanism II since 2004

The Bretton Woods System

- The Bretton Woods conference 1944
  - Integration started when Europe was still at war
- The Bretton Woods System 1944 – 1973
  - Fixed exchange rates of most important currencies
- Institutions
  - Dominant role of the United States – the US-$
  - World Bank and IMF

Breakdown and Reorganization

- Collapse of the Bretton Woods System 1973
  - Increasing international discrepancies
  - Different inflation
  - Trade deficits
  - Vietnam war
  - US monetary policy
- European reaction
  - The snake exchange rate system – EMS I
- During a destabilized economic situation
  - High inflation rate
  - Oil price shocks
  - Increasing unemployment
  - Frequently realignments

5. European Monetary Integration

First Attempts

- Treaty of Rome (1958)

  Art. 2: “…the Community shall have as its task, by establishing an economic and monetary union, to promote throughout the community a harmonious and balanced development of economic activities.”

- 1971: Werner Plan to strengthen coordination of economic policies. The Member states promise to coordinate their budgetary and monetary policies and reduce the margins of fluctuation between their currencies.

Exchange Rate Agreements

- 1972: Setting up the currency “snake”: the six members agree to limit the margin of fluctuation between their currencies to 2.25%
- July 1972: first severe crisis of the “snake in the tunnel” (leaving of Italy until 1979, and UK until 1990)
- December 1978: The European Council meeting in Bremen agrees the French-German proposal to launch the European Monetary System (EMS I)

EMS I

- March 1979:
  - European Monetary System (EMS I) comes into force
  - Eight participating member states (UK stays outside) are required to maintain their exchange rates within certain fluctuation margins (+/-2.25% bands or Italy +/-6%)
  - Eleven realignments between 1979 and 1987
- 1981: Creation of the European currency unit (ECU)

EMS II

- That means:
  - Capital controls pervasive
  - Wide inflation differentials
  - Preparation of the currency union
  - Dominant role of the “Deutsch Mark” (DM) and the German Central Bank (Deutsche Bundesbank)

The treaty of Maastricht I

⇨ Realization of the European Monetary Union

- July 1st, 1990: The first phase of the Economic and Monetary Union (EMU) comes into force:
  - Removal of all restrictions on capital movements (exceptions: Spain, Portugal, Greece, Ireland – until the end of 1995)
  - Increased coordination of individual economic policies
  - More intensive cooperation between central banks

The treaty of Maastricht II

- December 1991
  - Legal constitution of economic and monetary union
  - Introduction of the single European currency, the ECU, by 1999 at the latest
  - Completion of the 4 conditional freedoms of an Economic Union
  - Convergence criteria
  - Coordination of economic policy
  - No bail-out clause
  - Institutional framework for the ECB

⇨ ***step by step towards the Euro***

The treaty of Maastricht III

ulm university universität uulm

- January 1994: second phase of Economic and Monetary Union starts and the European Monetary Institute (forerunner of the European Central Bank) is established
- June 1997: The treaty on the EU
  - Interdependence of *economic policy* convergence <u>and</u> *monetary policy* convergence in the EMU
  - <u>Stability and growth pact</u> for ensuring budgetary discipline in the EMU

Economic Policy Convergence

ulm university universität ulm

Policy

Economic Policy Convergence

centralized

decentralized

Political union with competencies of structural policies and cyclical policy

A common economic constitution for the union

(irreversible, de iure European Economic Union inside a political union)

A legally binding common economic policy and competencies for shaping the labor markets by directives or agreements like the Stability and Growth Pact

(quasi European Economic Union with sanctions)

Coordinating the economic and labor market policies = factual

communizing by convergence criteria and convergence programs

(quasi European Economics Union with rights to opt out)

Monetary Policy Convergence

Policy

Monetary and Exchange Rate Policy Convergence

decentralized	centralized
Coordinating the monetary and exchange rate policies	Centralization of - currency - monetary policy (status of the ECB) - exchange rate system - exchange rate policy
⇨ quasi-monetary union with the right to opt out	⇨ de jure monetary union

The treaty of Maastricht IV

- 1998: European Council decides that 11 member states satisfy the conditions for adoption of the single currency on January 1st, 1999
  - The Commission and the European Monetary Institute set out conditions for determination of the irrevocable conversion rates for the Euro
  - Creation of European Central Bank (ECB)

Single currency and criteria I

- Price stability

  Inflation rate does not exceed by more than 1.5 percentage points of, at most, the three best performing member countries

- Interest rates

  Member states have had an average nominal long-term interest rate that does not exceed by more than two percentage points of, at most, the three best performing member states in terms of price stability

Single currency and criteria II

- Budget deficits

  Budget deficit: max. 3% of the GDP

- Public debt

  The ratio of government debt should not exceed 60% of GDP

- Currency stability

  EMS membership without severe tensions for at least two years before the examination

Convergence criteria in 1999

	Inflation	Interest rates	Budget deficit	Public deficit
Belgium	1.4	5.7	-2.1	122.2
Germany	1.4	5.6	-2.7	61.3
Finland	1.3	5.9	-0.9	55.8
France	1.2	5.5	-3.0	58.0
Greece	5.2	9.8	-4.0	108.7
Ireland	1.2	6.2	+0.9	66.3
Italy	1.8	6.7	-2.7	121.6
Luxembourg	1.4	5.6	+1.7	6.7
Netherlands	1.8	5.5	-1.4	72.1
Austria	1.1	5.6	-2.5	66.1
Portugal	1.8	6.2	-2.5	62.0
Spain	1.8	6.3	-2.6	68.8
Reference	**2.7**	**7.8**	**-3.0**	**60.0**

Stability and Growth Pact

– From convergence to the permanent regime

– Excessive deficits

– Warnings and corrective actions

– Sanctions

Convergence criteria in 2005

	Inflation	Interest rates	Budget deficit	Public deficit
Belgium	2.5	3.4	+ 0.1	93.3
Germany	1.9	3.4	- 3.3	67.7
Finland	0.8	3.4	+ 2.6	41.1
France	1.9	3.4	- 2.9	66.8
Greece	3.5	3.6	- 4.5	107.5
Ireland	2.2	3.3	+ 1.0	27.6
Italy	2.2	3.6	- 4.1	106.4
Luxembourg	3.8	3.4	- 1.9	6.2
Netherlands	1.5	3.4	- 0.3	52.9
Austria	2.1	3.4	- 1.5	62.9
Portugal	2.1	3.4	- 6.0	63.9
Spain	3.4	3.4	+ 1.1	43.2
Reference	2.5	5.4	-3.0	60.0

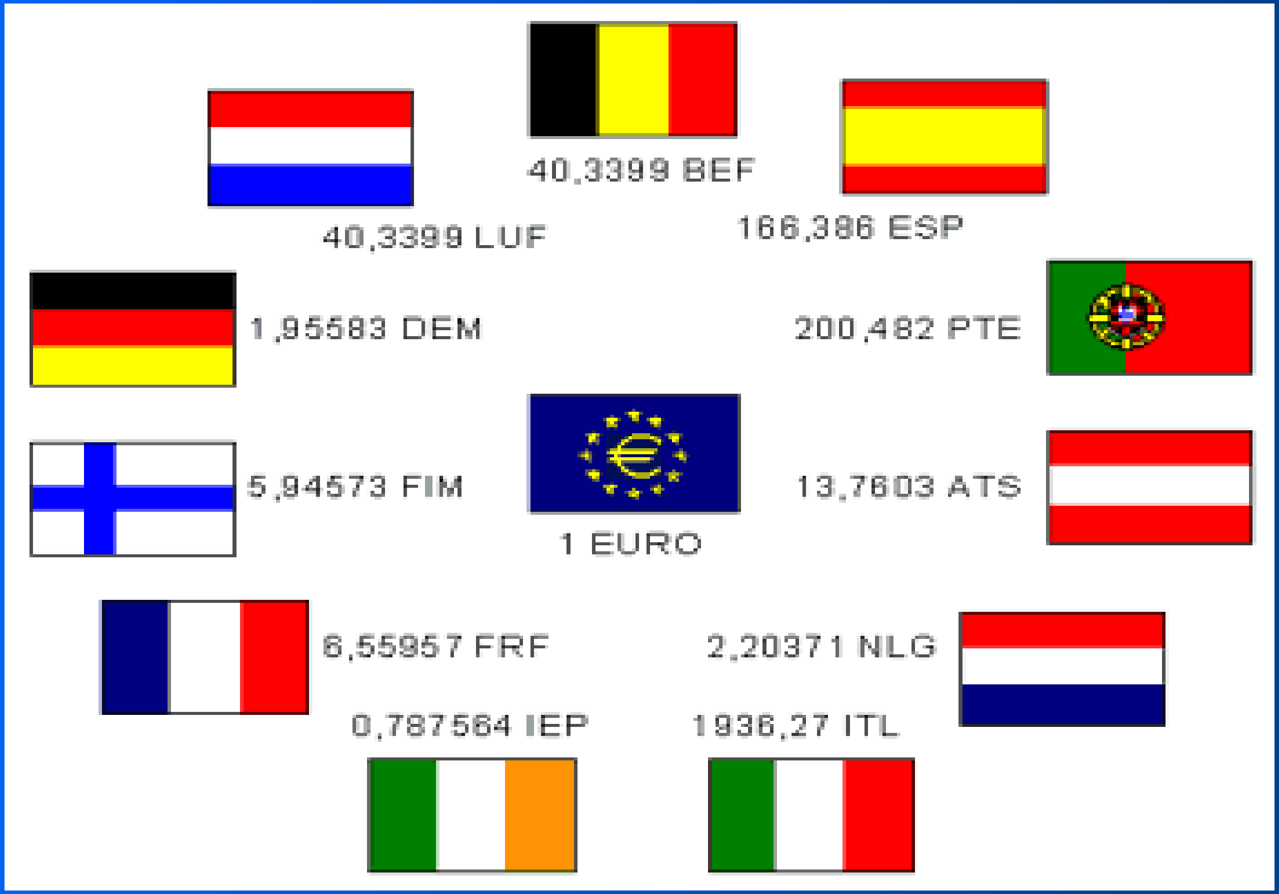
European Monetary Union I

- January 1st, 1999: The third phase of the European Monetary Union (EMU)
  - The Euro is officially launched: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, The Netherlands, Portugal and Spain adopt the Euro - € - as their official currency
  - Fixed exchange rates

European Monetary Union II

ulm university universität ulm

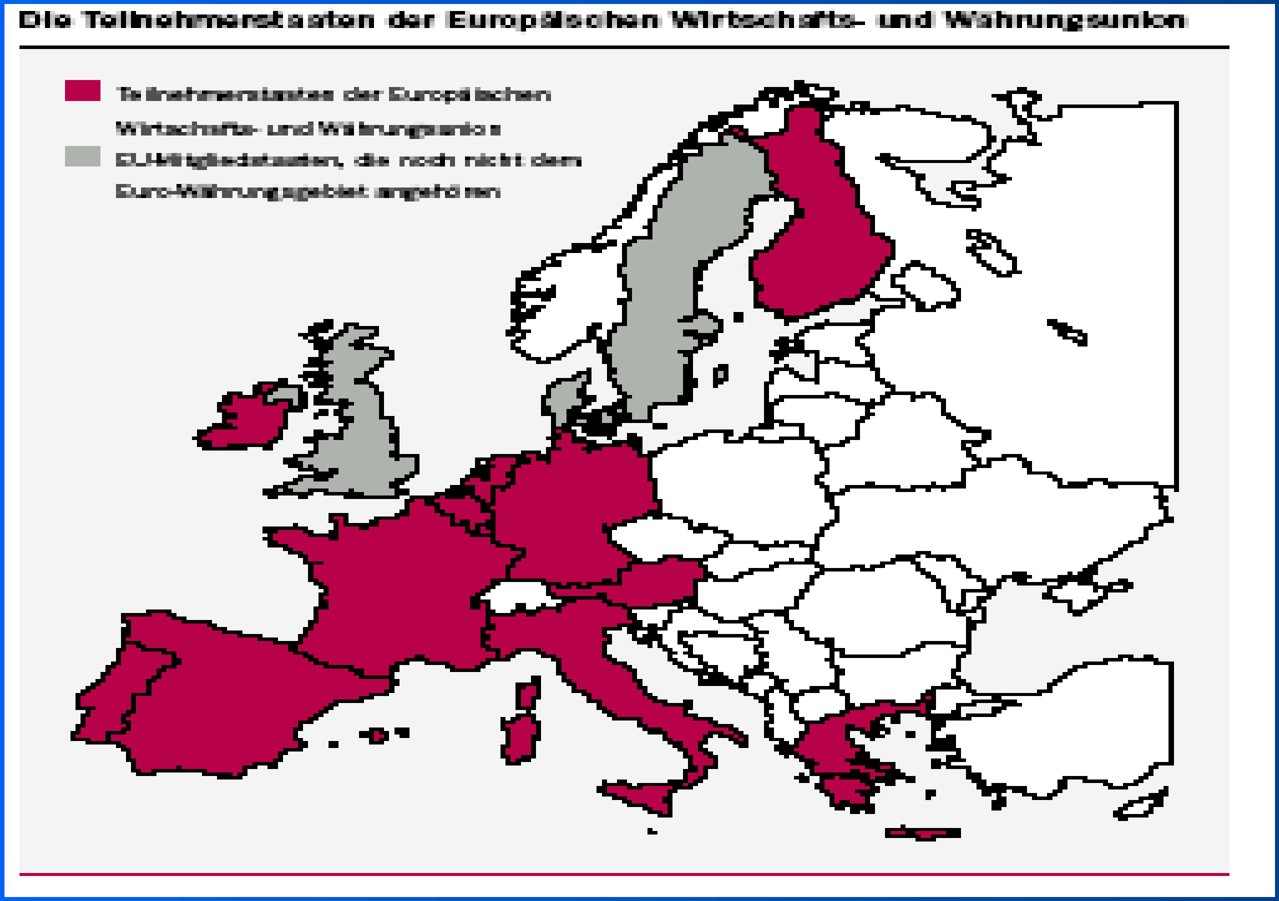
Euro exchange rates



European Monetary Union III

- January 1st, 2002: The fourth phase of the EMU
  - Introduction of the Euro as the single legal tender
  - Exchange of national currencies for Euro
  - Coins and notes
  - *12 member states*

Member States of the EMU



The European Monetary Union

ulm university universität ulm

- *The 12 member states:* Germany, France, Italy, Belgium, Netherlands, Luxembourg, Ireland, Austria, Finland, Spain, Portugal, Greece (since 2001)
- Non-members of the Monetary Union:
  - United Kingdom
  - Sweden
  - Denmark
- Further accessions?

ERM II

- Remove of the EMS I by the Exchange Rate Mechanism (ERM II)
  - Standard fluctuation band of +/-15%
  - No realignments for at least two years
  - Member of at least two years before introducing the Euro currency
- *Candidates in ERM II since 2004/2005:* Denmark, Estonia, Lithuania, Slovenia, Malta, Cyprus, Latvia
- Slovenia joins the EMU in January 2007
- Expectations?

ERM II

ulm university universität ulm

- Outside ERM II:
  - Czech Republic
  - Hungary
  - Poland
  - Slovakia
  - Sweden

Conclusions

- Monetary integration:
  - aims,
  - advantages and
  - disadvantages
- Is Europe an optimal currency area?

  ⇨ Not at this time!
- The ‘long way’ to the European Monetary Union