UDC 339.738

European Monetary Union: limits to growth or bifurcation point*

OLEKSANDR SHAROV[1]

ABSTRACT. The paper presents the background and process of the EU monetary union establishment with regard to historical experience of European countries involving previous attempts of currency integration between separate countries. The author also analyzes methods of solving various theoretical and practical problems arising during the process. In particular, it is pointed out that the majority of the problems were caused by neglecting monetary integration principles, the need for observing which had been clearly stated yet at the preliminary stages of the integration process. Special emphasis is made on reviewing current development stage of the monetary union, in particular, with regard to problems caused by the financial crisis in "peripheral countries" of the Union as well as by concurrent intensification of cooperation in the field of banking and fiscal issues. In this context, the trends of further European monetary integration development are also considered. As resulted from analysis, the author concludes that the European Monetary Union had exhausted its energy for development along previously assigned trajectory and reached the bifurcation point, whereas its further improvement or gradual preservation and decline depend upon the direction in which the point is passed.

KEY WORDS: currency exchange rate, monetary union, euro, European currency snake, single currency

Introduction

The range of problems related to the European Monetary Union establishment and functioning proves one of the most widely and profoundly analyzed by both domestic and foreign authors such as economists, theorists, bankers and businessmen, politicians and analysts, speaking of which the classical work by R. Mundell[2] is to be mentioned with its main provisions considered the European Monetary Union theoretical basis. As regards more recent studies, the mentioned processes are described detailed enough in works by K.Dyson[3], as well as in those by D. Gros and N.Thygesen[4]. The

* This article was translated from its original in Ukrainian

[1] **Oleksandr Sharov** – Doctor of Economics, Professor, Head of the Foreign Economic Policy Department of the National Institute for Strategic Studies, Chief Research Scientist with the Institute for Economics and Forecasting, National Academy of Sciences of Ukraine. Research areas: study of the globalization financial aspects, international monetary relations and the state foreign economic policy. Email address: osharov@niss.gov.ua.

[2] *Mundell R,* "A Theory of Optimum Currency Areas." American Economic Review, № 51, 1961, pp.657- 665

[3] See, i.a.: *Dyson K.* Elusive Union: The Process of Economic and Monetary Union in Europe - London: Longman, 2004; Dyson K., Featherstone K., The Road to Maastricht. Negotiating Economic and Monetary Union - Oxford University Press, 1999

IEP, № 20, (2014) pp.21 — 42

ISSN 1811-9832/2014/№ 1 (20)

detailed reviewing of the monetary union establishment legal aspects is provided in the work by R.M. Lastra, the British International Financial Law Professor[5]. Interesting outlook from the perspective of professionals observing the monetary union further development problems a bit 'from outside' is presented in the work by professional financiers J. Nordvig and N. Firoozye[6], as well as in that by the Union potential members – Polish bankers S. Kawalec and E. Pytlarczyk.[7]

In general, experts have no single opinion as to the reasons leading to the monetary union crisis. The most common, however, is the so-called "German view" criticizing fiscal discipline violations in some countries. Another one (the "Keynesian view") lays the blame for the crisis on major sovereign debts in peripheral countries resulting in sustained current account imbalance of the eurozone peripheral countries (which, after the 2008 financial crisis proved impossible to finance by means of raising debt capital on the market basis). As already mentioned, in this regard the main issues are related to the impossibility of applying own national monetary and exchange rate policy. Thus, "the [k]ey challenge to the eurozone is that the currency regulation mechanisms are not working, therefore it is required to find new tools for steadying the external imbalances situation in terms of the classical payment balance crises. The current eurozone policy aimed at liquidity support for distressed countries only exacerbates the accumulated imbalances and fails to provide for the crisis situation overcoming"[8]. At the same time, the single monetary policy can not always take into account different objectives inherent in the eurozone economies as a result of quite different levels of economic, social and institutional development. Particularly significant problems arise from the differences in the banking and fiscal system of the EU countries.

The mentioned problems take on special significance for Ukraine after signing the free trade agreement with the European Union, since interest in the developments of monetary relations within the Union is thus transferred from the purely theoretical plane into that of practice.

---

[4] *Gros D., Thygesen N.,* European Monetary Integration. From the European Monetary System to Economic and Monetary Union - London: Longman, 1998

[5] *Lastra R.M.* Ch 6: History of monetary integration in Europe / In: The Legal Foundations of International Monetary Stability - Oxford University Press, 2006

[6] *Nordvig J., Firoozye N.* Rethinking the European monetary union/ Wolfson Economics Prize 2012 - Final submission

[7] *Kawalec S., Pytlarczyk E.* Controlled dismantlement of the Eurozone: A proposal for a New European Monetary System and a new role for the European Central Bank/ National Bank of Poland, Working Paper No. 155- Warsaw, 2013

[8] *Nikolaichuk S., Khomyak V.* Eurozone crisis: result of lacking fiscal discipline or accumulation of external imbalances? / Bulletin of the National Bank of Ukraine, No. 2, 2013, p.28 [In Ukrainian].

Historical retrospective of the monetary union establishment in Europe

The first attempt of creating a monetary union in the contemporary (modern) history of Europe could perhaps imply the Latin Monetary Union. As in late March 1803 (on 7 Germinal, Year 9 of the French Revolution) France introduced a new monetary system based on the decimal system of calculation, this caused practical interest in many countries. The adopted law introduced a new currency (the 5 gram, 90 percent fine silver franc) as well as affirmed the fixed ratio between silver and gold at the rate of 15.5:1 as established by a royal edict dating back to October 1785. The new monetary system convenience has led to first Belgium (in 1832) and subsequently Switzerland (in 1850) and Italy (in 1862) introducing the same monetary system, **thus de facto ensuring common monetary area functioning based not on formal agreements and administrative regulation, but on the purely market mechanism.** However, the 1850 discovery of large gold deposits in California and subsequent influx of the "yellow metal" to Europe gradually led to the market mechanism "malfunctioning": during 1852-1861 the average price ratio of silver and gold in the market amounted to 15.37:1[9]. Naturally, under such circumstances speculative trading gained widespread, as conditioned by Copernicus Gresham law. In this regard, the "monetary unification" had to be revived through administrative measures.

Latin Monetary Union (*L'Union monŭtaire latine*) was established in November 1865 (started functioning in 1866) by France, Belgium, Italy and Switzerland formally agreeing to bring their currencies to the bimetallic standard with the fixed ratio between silver and gold of 15.5 to 1 (4.5 grams of fine silver and 0.290322 grams of fine gold). Coins of the Union member countries were mutually accepted by national treasuries as legal tender. The agreement was reached that the Monetary Union would remain effective until 1880. Gradually, several more countries joined the Union: Spain and Greece (1868), Austria-Hungary, Venezuela, Serbia, San Marino and States of the Church (1889). Certain other countries also used the Latin Monetary Union standards in practice, while not joining it formally (Albania, Bulgaria, Romania, etc.). In 1885, the gold content of Russian coins was fixed at the level identical to that of French coins. Earlier still, a similar gold content (with no reference to silver) had been adopted for the Finnish mark.

---

[9] *Essars P. de, Raffalovich A., Walker B. E.* A History of Banking in all the Leading Nations, vol. 3 (France, Italy, Spain, Portugal, Canada), part VIII: The Latin Monetary Union/The Online Library of Liberty [Electronic resource]. – Access mode: http://oll.libertyfund.org/?option=com_staticxt&staticfile=show.php%3Ftitle=2239& chapter=212158&layout=html&Itemid=27

The monetary integration policy was regarded by France in the context of general political line to create a pan-European confederation, **and thus the monetary union was to become the first stage of the general unification of the European countries.**

However, **contradictions to market economy requirements inherent in the agreements kept manifesting themselves also in the future.** Belgium was the first to raise alarm and was supported by France. Attempting to solve these problems, the Union member states were forced to hold a series of international conferences. The best known of those was the 1867 Paris International Monetary Conference held as a part of the World Exhibition programme. Some experts believe that it led to the gold standard creation, which is partly true: the issue of bimetallism abandonment at Prussia initiative was raised during debates and soon thereafter (in 1871) the said country (gaining a significant contribution from the defeated France) introduced the gold mark. A gradual transition to the gold standard of some other countries can therefore be considered as a certain alternative to the Latin Monetary Union, although no similar unification was performed between the "gold bloc" countries.

Possibly, the Latin Monetary Union imputation of leading to economic stagnation resulting in World War I[10] is too radical, however certain negative lessons of its existence should certainly be learned. First of all, the Latin Monetary Union experience has shown that for a successful monetary union it is crucial that the single currency exchange rate would be realistic and would not cause incentives for speculative attacks. In addition, the monetary union members should adhere to a common monetary policy. At that, the monetary policy unification is only one of the mutual concessions of a monetary union members, which should be supplemented by rejecting independent monetary policies (as one of the national sovereignty economic elements), in practice implying transfer of authority for governing issues of money supply, price level, interest rates and exchange rates to a common supranational body. Fiscal innovations can not be avoided, either.

The elimination of currency unions in Europe after World War I due to their inefficiency did not however solve the all-European economic problems and after World War II Europe was hard pressed again. Of all the European countries participating in the war only the Great Britain experienced no GDP decline. Instead, GDP of France fell to the 1891 level, whereas that of Germany was

---

[10] Cigpapers. Latin Monetary Union 1865 t0 1927/ Web:The British National Party, 04.04.2013 [Electronic resource]. – Access mode: http://www.bnp.org.uk/news/national/latin-monetary-union-1865-1927

decreased to the level of 1908. The lack of reliable currency has led to significant restrictions of foreign trade, which had to be based on the U.S. dollar, or even on barter.

Given such conditions, in July 1950 the Organization for European Economic Cooperation created the **European Payments Union (EPU).** The European Payments Union operating principle implied that at the end of each month the net balance of payments between the member states was forwarded to the Bank for International Settlements in Basel (appointed as the Union payment agent) for subsequent offsetting claims. The remainders were consolidated thus defining a positive or a negative balance not of individual countries but of the Union as a whole. At that, the balance was calculated in a conventional European unit (European Unit of Account – EUA) equal to the U.S. dollar. Debts were originally covered by loans, but in terms of ultimate calculation implied payments in USD or in gold. Each country had a 15 per cent quota of its trade volume with the Union member states for 1949. As long as liabilities of a country to EPU did not exceed 20 percent of its quota, the deficit financing was automatically carried out by virtue of a loan and did not require repayment. However, if the liabilities exceeded the 20 percent limit, immediate repayment of 20 percent of the total debt in gold was imposed. Debts of 40, 60 and 80 per cent of the quota were to be repaid in gold or USD. Positive balance was treated similarly, but using other percentage limits. In case the set quota was exceeded, settlements with the Union were made in gold (unless subject to exceptional circumstances the EPU Board expanded the credit volume related to such a country). The accumulated claims (positive balance) could be converted into goods and hard currency (USD) only partially and subject to a certain delay. Until the set quota was completely filled, the creditor country could only receive gold within the 40 per cent of its total net export to other EPU countries.

Such lending mechanism within EPU was beneficial not only for the debtor countries, but also for the creditor countries, since due to this system the creditor countries could expect at least a partial payment for their goods in gold or USD (instead of trading against a totally non-convertible currency). In addition, the creditor countries were to make a smaller contribution in gold to the initial capital than the debtor countries (the difference was covered by a special loan to EPU from the USA in the amount of USD 350 million under the Marshall Plan). At that, the existing rules provided for financial assistance depending on actual efforts of a debtor to remedy the situation. Provided the efforts exceeded the set debt quota, independent experts and the EPU Board would prepare proposals to the Council of the Organization for European Economic Cooperation on adjusting economic policy of the respective debtor

country. Thus, certain guarantees were provided that the debtor country would be able to improve its economic state and repay the debts. Finally, the EPU membership rules stipulated gradual trade liberalization, establishment of common customs duties for all member states to be followed by their significant reduction. Such an approach contributed to active development of multilateral trade. Trade volumes between the EPU countries increased from USD 10 billion in 1950 to USD 23 billion in 1959. Although trade with the United States developed at a slow pace, during this period the USD reserves of the EPU countries have doubled.

The European Payments Union existed from July 1, 1950 to December 27, 1958, as it was eliminated due to restoration of the member states currency convertibility. During this time, the balance of payments (both surplus and deficit in mutual trade) of the EPU amounted to USD 46 billion with circa half thereof (USD 20 billions) repaid on the payment exchange basis, a quarter thereof (USD 12.6) repaid due to subsequent changes in the state of balance (occurrence of surplus, through which previous deficit temporarily credited by EPU was repaid), whereas payments in gold or hard currency were made for redemption of debts only in the amount of USD 10.7 billion (i.e. payments in foreign currency have been reduced by more than 75 percent)[11].

The EPU was replaced by the European Monetary Agreement signed back on July 29, 1955 and entering into force on December 27, 1958 being aimed at further development of foreign trade and currency convertibility. The Agreement was governed by the Organisation for Economic Cooperation and Development. The Agreement stipulated establishment of the European Fund in the amount of USD 600 million (in July 1959 after Spain had joined the Fund, the amount was increased to USD 607.5 million). The funds were used for crediting temporary payment balance deficits. In September 1961 the Agreement was joined by the United States and Canada. At the end of 1972, the Agreement was terminated with functions of crediting payment balance deficits of Western countries transferred to the International Monetary Fund in full.

Unlike EPU, the European Monetary Agreement provided not quite for creation of a payment system, but rather a kind of "code of conduct" of the member states in terms of their currencies convertibility. In particular, the countries voluntarily restricted fluctuations of their currencies against USD by means of 0.75% exchange rate band (although the IMF rules set a 1% limit). In

---

[11] *Eichengreen B.* The European Payments Union : History and Implications for the Evolution of the International Financial Architecture /OECD Development Centre, Paris, March 2001- [Electronic resource]. – Access mode: http://www.jbmacedo.com/oecd/triffin.html

addition, the countries provided each other with certain limited guarantees of compensation in case of exceeding currency fluctuation limits. From a technical point of view, the agreement did not provide for the automatic crediting of deficits (as in the EPU): European Fund loans were granted under individual terms with the crediting period not exceeding 2 years. At that, the European Fund Board of Directors held regular consultations with debtor countries on improvement of their monetary policies and practical issues of payments balance adjustment[12].

The Treaty of Rome on the European Economic Community establishment was based on the fact that the issues implying balance of payments adjustment (including by means of exchange rate adjustment) as well as ensuring confidence in national currencies fell within the competence of national governments and central banks cooperating on a bilateral basis. However, as early as in 1962 the European Commission has prepared a package of proposals on coordination in the field of monetary and economic policy within the entire integration process. In 1969, the initiative for greater coordination of economic and monetary cooperation was expressed in **Barre Report**, which recognized that conclusions on the common agricultural policy indicated that its impact went well beyond the basic sector of the economy and concerned also the general level of prices, government finance and monetary relations between the Community member states[13]. In this regard, proposals were introduced as to implementing closer ties between strong cooperation in the field of economic policy and the implementation of a monetary cooperation mechanism within the European Economic Community based on the Treaty of Rome principles. At the same time it was emphasized that such monetary cooperation mechanism should not be seen as a replacement of the international monetary cooperation mechanism. On the contrary, it should be set up in such a format so it could completely work with the international mechanism without additional complications and would not affect obligations of the Community member states to the international currency (monetary) institutions[14]. Upon consideration of these proposals at the Hague meeting in March 1969, the heads of the Community states and governments pointed out some fundamental principles based on which the economic and monetary Community should be established. In particular, this implied the

---

[12] *Ungerer H. A* Concise History of European Monetary Integration: From EPU to EMU, 1997, p.30

[13] Commission Memorandum to the Council on the co-ordination of economic policies and monetary co-operation within the Community / Secretariat of the Commission, Feb.12, 1969, p.5 – [Electronic resource]. – Access mode: http://ec.europa.eu/economy_finance/emu_history/ documentation/chapter2/ 19690212en015coordineconpoli.pdf

[14] Ibid., p.12

free trade principle and coordination with the processes taking place in the international economic relations as well as within the system of international economic cooperation in general. Special attention was paid to the exchange rate fixing system. The outcome document of the meeting pointed out the importance of ensuring their stability and inadmissibility of the flexible exchange rate fixing system (including the so-called 'crawling peg'), since this would contribute not to unification (convergence) as such, but to separation of national economies rather. A resolution as to the phase-based principle of establishing the economic and monetary union was also adopted: the first phase (1970-71) implied that the work was focus on solving preliminary issues; the second phase (1972-75) implied preparation to the union establishment, whereas and the third phase (1976-78) was dedicated to the actual union establishment[15].

In March 1970, a special Committee was established (headed by P. Werner, the Prime Minister of Luxembourg) and entrusted with preparing a plan for the monetary union establishment. According to Barre Report recommendations, the central banks created a balance of payments support fund, from which member states could receive up to USD 1 billion for the period of up to 6 months. In October of the same year, the Special Committee report was published laying out the monetary union phase-based establishment plan with the phases ranging from solid fixing of reciprocal rates to the single currency introduction.

Approaches of the experts preparing the report came to differ. The German experts (in particular, K. Schiller) as well as Dutch ones and some Italian experts believed that the wording "economic and monetary union" itself meant that firstly an economic union should be created followed by establishing the monetary one. The French and Belgian members of the group argued instead that economic convergence was logically based on a more profound cooperation in the field of monetary matters. Therefore, from their perspective it was necessary to promptly make decisions on restricting exchange rate fluctuations, creation of a common reserve fund, etc. This difference in approaches reflected diversity between the French and German visions of further integration. Perception of the prospects supported by France was based on the fact that the economic system of the Community with the fixed exchange rates would allow member states to maintain national sovereignty in matters of economic and fiscal policy. However, this did not comply

[15] Commission memorandum to the Council in the preparation of a plan for the phased establishment of an economic and monetary union/ Commission of the European Communities, Secretariat-General : Brussels, 4 March 1970, pp.5,6,10 - [Electronic resource]. – Access mode: http://ec.europa.eu/economy_finance/emu_history/documentation/compendia/19700304en019commplanphasese.pdf

with the interests of more stable countries, primarily, Germany, which argued that creation of a monetary union without economic harmonization was doomed to failure. Moreover, they suspected that countries having permanent problems with balance of payments (such as France) focused on creation of a monetary union in order to be able to resolve this problem without implementing the necessary economic reforms, through using common reserve funds for deficit financing (with the funds to be provided mainly by Germany). P. Werner himself tried to stick to a neutral position and supported parallel measures for economic and monetary cooperation (although in certain expressions at the early stages of the report preparation he inclined to the "monetarist perspective").

Another cause of the disagreement was the issue of establishing supranational bodies in the field of economic and monetary policy. K. Schiller, the Germany's Federal Minister of Economic Affairs, advocated strong coordination of fiscal policy at the EEC level, up to establishment of common bodies (such as the Central Bank) inclusive. Instead, the French again opposed any proposals that could lead to the national sovereignty restriction.

Werner Plan was at last officially presented on October 8, 1970 at the EEC Council of Ministers meeting in Luxembourg. The main idea was to create a common area where goods, services, workforce and capital could move freely, while foreign currency transactions would not stumble upon any complications and were not exposed to exchange rate risks. Such an economic and monetary union implied not only introduction of a single currency (which would be supported by the single currency reserves), but also creating a common capital market as well as achieving a high level of tax harmonization. This, in turn, still provided for transfer of the right to make certain decisions from the national level to the 'European' one (especially, in terms of fiscal policy) and centralization in the field of monetary policy[16]. However, implementation of the adopted plan failed. The matter was that the debate around European monetary integration took place against the background of an acute global monetary system crisis, which could not but affect the interests and plans of the EEC states. Specifically, in August 1971, the United States denied the right of central banks in other countries to convert U.S. dollars into gold, which was actually made in response to the demands of USD devaluation in relation to gold (in legal terms: raising the official price of gold). After making that decision the US Federal Reserve

[16] *Danescu, Elena Rodica.* 'The Werner Report'/ CVCE, 2012, pp.2-3 - [Electronic resource]. – Access mode: http://www.cvce.eu/obj/%20the_werner_report-en-baa6e5b2-7db4-4c43-8412-3cb2eb6315e2.html

System Chairman P. Volcker went to London for attending the 'group of 10' meeting where he attempted to explicate the U.S. position. In particular, he spoke of the need to transit to a system of floating exchange rates. However, only Germany supported this approach at first. Naturally, the new idea, alternative concepts of fixed exchange rates incorporated in the EEC monetary union creation project had had negative impact on the intention of the plan's rapid implementation. In late November, the issue had been discussed at the principal meeting of the "group of 10" in Rome. Currently, though, the issue specifically implied revaluating currencies of the OECD countries in relation to the U.S. dollar by the average of 11 percent (and subsequent transit of the German mark rate to free floating). However, the French finance minister claimed having no authority to make such a decision. Therefore, discussion of the proposal between the U.S. and France was adjourned to mid-December along with supplementing agenda with a meeting between the two Presidents in the Azores. During the negotiations, G. Pompidou (representing the position of all EEC countries) succeeded in reaching an agreement with R. Nixon as to devaluation of the U.S. dollar by 8.5% (from USD 35 to 38 per 1 tr. ounce). As a result of these negotiations, France refused to implement *Werner Plan*.

However, this did not imply total refusal from European countries cooperation in matters of monetary policy. The U.S. dollar devaluation agreement reached in the Azores had been formally approved three days beforehand at a meeting of the 'group of 10' finance ministers and heads of the central banks in Washington, and called 'The Smithsonian Agreement'. The Agreement also provided for the extension of the currency fluctuation limits against the U.S. dollar by ± 2,25% factor. At the same time, the EEC countries decided to proceed with *de facto* implementation of at least certain provisions of the *Werner Plan*, the result of which was signing the Basel Accord in March 1972 introducing the exchange rate coordination mechanism known as the **"European snake in the tunnel"**. The EEC Member States have extended the limits of reciprocal currency fluctuation by ± 1,125%, i.e. the currency mutual fluctuation corridor was widened to 2.25%. According to the Smithsonian Agreement all the IMF members should provide for the maximum permissible exchange rate deviation in relation to USD making ± 2,25%, i.e. the total fluctuation amount was not to exceed 4.5%. Thus, mutual currency exchange rate fluctuation of European currencies was concentrated in a narrow range ("the snake"), but in relation to the American currency it could not go beyond a wider range ("the tunnel"). Use of this regime proved short-lived, as it caused serious difficulties and contradictions.

Further search for new forms of monetary integration has led to the EEC Council establishing the **European Monetary Cooperation Fund** in April 1973[17] with its task being to provide financial support in assuring exchange rate stability (subject to the "currency snake" mechanism). The Fund's financial resources were accrued by depositing 20 percent of the gold and foreign currency reserves of the member countries and accounted in the conventional European Currency Unit (ECU)* equal to 0.88867088 grams of fine gold *(i.e. meeting the USD "gold content" prior to its devaluation two months before)*, whereas the Bank for International Settlements in Basel was appointed as agent of the Fund. It was expected that the Fund would operate until introduction of the single European currency.

Under these conditions the "European currency snake" countries cancelled their currency exchange rate fluctuation limits against the U.S. dollar and other currencies (i.e., the "snake" went out of the "tunnel"). At the same time the mutual EEC countries currency exchange rate fluctuation limits were expanded to ± 2,25%. This renewed regime was not joined by Great Britain, Italy and Ireland. Due to the foreign exchange position instability during 1974-1978 the following European currencies had to be withdrawn from the "currency snake" regime: the Italian lira – in 1973, the French franc – in 1974, and the second time in 1976 (after returning to the system in 1975), the Swedish krona – in 1977, and the Norwegian krone – in 1978. This situation has forced the EEC countries to seek another option of deepening monetary cooperation, which resulted in establishing the **European Monetary System** (EMS) in March 1979. The main element of the new system was the renewed European Currency Unit calculated on the basis of own "currency basket"**, in relation to which parities of EEC countries currencies were

---

[17] Regulation (EEC) No 907/73 of the Council of 3 April 1973 establishing a European Monetary Cooperation Fund/ Official Journal of the European Communities 05.04.73, pp. L 89/2-3 – [Electronic resource]. – Access mode: http://ec.europa.eu/economy_finance/emu_history/documentation/chapter6/19730403en04euromonetcoopregul.pdf

* It should be noted that European Unit of Account equivalent to USD 1.00 as established back in 1950 within the European Payments Union circulated in parallel. After EPU winding-up in mid 1950s, this unit was still used within the settlement system under the Lome Convention on EEC trade cooperation with the "third world" countries and in operation of the European Investment Bank. Since 1975, it was accounted on the "currency basket" basis (initially, similar to the SDR "basket" and amounting to USD 1.20635) and used in all EEC institutions, temporarily replacing the European Currency Unit - ECU

** From the previous version it was distinguished, above all, by including only European currencies (i.e., the U.S. dollar was not included): it was originally based on the basket of the same nine currencies, which once had formed the basis of European Unit of Account (EUA): the West German mark, the French franc, the British pound sterling, the Dutch guilder, the Italian lira, the Belgian franc, the Irish pound, the Danish krone and the Luxembourg franc. After joining the EMU by other countries, the "basket" also incorporated their currencies: from 1984 – the Greek drachma, in 1989 – the Spanish peseta and the Portuguese escudo. Upon creation the ECU was equal in value to the SDR, but gradually this equality grew disrupted on account of their "baskets" different composition.

established. In case their rate fluctuation exceeded permissible limits, central banks of the ECU member countries were obliged to redeem currencies of the partners in unlimited amounts. The main rate fluctuation limit in relation to ECU was set at ±2.25% of mutual central rates for seven currencies, and ±6% for the eight one – the Italian lira. The exchange rate "abnormal" state indicator was the so-called 'threshold of maximum divergence'[18]. In case of the relevant currency exchange rate reaching the said "threshold", the banks were obliged to take action for its stabilization. This system was called the Exchange Rate Mechanism (ERM).

The initial ECU issue was based on the deposits available at the European Monetary Cooperation Fund as well as on portions of the gold and foreign currency reserves of the EMU member states (per 20% of each type of reserves). These deposits were regarded as three-month loans. At that, gold deposited with EMCF was valued at the average market price for the last 6 months (but not exceeding the market price on the penultimate day of the period), whereas deposits in USD were converted to ECU based on the U.S. dollar market value fixed two business days prior to the date of conversion.

In 1986, the Single European Act has introduced certain economic prerequisites of fair and loyal competence as well as long-term stability in the domestic market. In addition, the Act referred to the European Monetary Union and deepening of the monetary cooperation between the Community member states, in particular, implying the European Monetary System and the European Currency Unit. Under the Act relevant provisions were introduced to a new article of the EC Treaty (Article 102 a). In the same year, a decision was adopted at the EC Hanover June summit to create an Ad hoc Committee for processing the new plan for establishment of an economic and monetary union (headed by J. Delors, the President of the European Commission).

The Delors Committee report on the EMU in the European Community was officially presented in April 1989. The Committee recommended to proceed towards establishment of an economic and monetary union in three phases whereby making significant steps to ensuring economic convergence, price stability and fiscal discipline before exchange rates of the member countries are fixed (including in terms of exchanging for the single currency). The first phase (from July 1, 1990) stipulated introducing more profound coordination of actions; the second phase implied institutional preparation for the final phase during which exchange rates were to be fixed and exchange to the single currency was to be performed.

---

[18] *Apel E.* European Monetary Integration : 1958 – 2002 – Routledge, 1998, p.68

Thus, the experts returned to the ideas expressed in the *Werner Plan*, after all, which was later acknowledged by J. Delors himself, saying: 'It could be said that the overall philosophy behind what we proposed and even the structure of the Delors Report were very heavily influenced by the Werner Report… The Delors Committee's report is a direct follow-on from the Werner Committee's report'[19]. No wonder, since the *Werner Plan* always acted as a kind of 'initiator' of ideas in discussions held in those days. This applies, in particular, to such initiatives on further European integration in general as the 'Spierenburg Plan', the 'Report of Lord Cromer's Group' and the 'Tindemans Report', or to R. Mundell's and G. Magnifico's concept of the 'parallel currency', as well as to a less known so-called 'All Saints Day Manifesto'*.

Economic and monetary union formation

In June 1989, at Madrid meeting the European Council generally approved the project of establishing the European Monetary Union proposed by Delors Committee, and in December of the same year it was decided at a meeting in Strasbourg to hold an intergovernmental conference on the issue for developing a specific course of action. Real preparatory work was commenced at the Economic and Financial Affairs Council (ECOFIN) meeting in July 1990, as the Monetary Committee's report on the subject was presented providing a detailed plan for implementing single monetary policy and introduction of the single currency. The report was approved by all Member States of the Community, with exception of Great Britain. Next month, the European Commission formally identified four theses forming the economic and monetary union basis:

- the monetary policy should be defined and implemented by the new institution of the Community – the European Central Bank.

---

[19] *Danescu E.* 'The Werner Report and the Delors Report', in A rereading of the Werner Report of 8 October 1970 in the light of the Pierre Werner family archives – Conclusion/ Sanem: CVCE, 2012, p.3 – [Electronic resource]. – Access mode: http://www.cvce.eu/content/publication/2012/4/5/72dae01a-6f2f-4b00-8caa-ba66db14dcac/ publishable_en.pdf

* In 1975, nine European economists addressed *The Economist* British weekly publication with a manifesto proposing introduction of a parallel single currency – the 'Europa', exchange rate of which with respect to national European currencies was supposed to be "floating" based on purchasing power changes (that is, to be indexed against inflation rate). Since the journal issue was released on November 1, the article was jokingly called "The All Saints' Day Manifesto for European Monetary Union", implying that the "All Saints" notion would be applied to all European governments, provided they agreed to the proposals. Later, the manifesto authors as members of expert groups published two reports on the subject for the European Commission (Optica Report '75, Optica Report 1976).

- the main objective of the ECB (which should act regardless of political pressure) is ensuring price stability.

- fiscal discipline should form the basis for close convergence of economic policy trends of individual states.

- the future common EEC currency shall be the European Currency Unit (ECU).

In December 1990, the second Intergovernmental Conference was dedicated to discussing creation of a political union. At that, consensus was reached that creation of a common market and an economic union can not be considered accomplished with no single currency introduced. Results of the two Intergovernmental Conferences were recapitulated at the Maastricht Summit (December 9-10, 1991), where it was also decided to establish a political union with EEC replaced by the European Union. These resolutions have been ratified by the European Parliament and signed by the heads of states and governments of the Union in April 1992 and called the **Maastricht Treaty.**

The economic and monetary union formation pursuant to the Treaty envisaged three phases.

During the *first phase* (till December 31, 1993) all restrictions on the free movement of capital within the European Union and between the European Union and third countries have been eliminated. Special attention was paid to ensuring convergence of economic development indices within the EU, to which end the member states adopted convergence programmes designed for several years and identifying specific targets and anti-inflationary and fiscal policy indicators. In terms of preparation for the introduction of a single currency such programmes focused on achieving consistently low inflation indices, consolidation of public finances and stability of exchange rates in relations between member states were presented to the EU Council for Economic and Financial Affairs.

During the *second phase* (from January 1, 1994 to December 31, 1998) the EU member states implemented the policy aimed at achieving widely known convergence criteria set forth by the Maastricht Treaty. In addition to the mandatory conditions the European Commission and European Central Bank retained the right to assess the state and development of the balance of payments of a pre-Accession country, market integration results, special workforce charges and other price indices.

Also during this phase (in 1994) the *European Monetary Institute* was established replacing the European Monetary Cooperation Fund with its main task being determination of the legal, organizational and material and technical prerequisites essential for the European Central Bank (establishment of which was to become a result of the Institute's activity). The European

Monetary Institute was also responsible for strengthening coordination of the Member States' monetary policies on the eve of the economic and monetary union establishment and as such authorized to provide recommendations to the national central banks.

In 1995, the European Union was joined by Finland, Sweden and Austria, whereas in December the European Council meeting in Madrid adopted the programme for introduction of the single currency, whose name was changed from the ECU to the euro. The programme implementation provided for identifying countries meeting the convergence criteria and being allowed to make transition to the euro, as it was performed in March 1998 with the EU Commission presenting a report on the EU countries achieving the convergence criteria stipulated under the Maastricht Treaty and thus recommending to admit eleven countries to the monetary union (all EU countries except Great Britain, Denmark, Sweden and Greece). In general, by the end of the second phase a noticeable convergence of the key macroeconomic indices of the union member states was achieved along with real progress in ensuring price stability, consolidation of public finances, reducing long-term interest rates, stabilizing the exchange rates of national currencies.

During the *third phase* (from January 1999) of the economic and monetary union formation the euro introduction programme has been implemented comprising *three stages:*

1. From January 1, 1999 to January 1, 2002: final fixing exchange rates of the EU member states national currencies, transfer of bank and corporate non-cash payments to euro, conversion of loans, deposits and long-term financial liabilities to euro, commencement of the European Central Bank operation (as established on the European Monetary Institute basis on June 1, 1998) as well as implementation of the single monetary policy in cooperation with central banks of the EU member states. During 1999-2001 in terms of non-cash settlements in the eurozone both euro and related national currencies were used simultaneously. The 'no compulsion' principle was applied: any business entity had the right to choose the currency for invoicing or payment.

2. From January 1, 2002 to July 1, 2002: cash circulation of banknotes and coins denominated in "euro" was introduced, while circulation of the national currencies of the member states was gradually eliminated.

3. From July 1, 2002: transition of all types of transactions and payments within the European Economic and Monetary Union to the euro has been accomplished.

Introduction of the euro as a single currency pursued primarily the aim implying establishment of the economic stability zone, facilitating currency exchange and coordination of economic policy

measures. Achievement of this goal required creation of a supranational currency regulation and currency control system, to which end the European System of Central Banks (ESCB) was established with the purpose of maintaining price stability and supporting the EU general economic policy[20].

Monetary union functioning problems

Introduction of the single currency gave rise to the issue of creating a new system of settlements under which all the currency union members would support real-time mode, allowing for virtually instanteous payments in any Member State. Payments within such a system would be possible only subject to availability of the necessary funds in a current (correspondent) account with the respective central bank. Provided funds are available, the transaction is performed immediately – in real time. In case of lacking funds in the account, the transaction is enqueued until the required amount is credited. This mechanism was called the Real Time Gross Settlements (RTGS) system. Clearance and settlement transactions in terms of national RTGS can be effected throughout the eurozone. All national RTGS are linked through a TARGET mechanism and form the European system of payments in euro. At the same time (in parallel with RTGS) the traditional correspondent banking mechanism is still applied allowing to carry out transactions not only in euro, but also in other currencies.

[20] Protocol (no 4) on the statute of the European System of Central Banks and of the European Central Bank - [Electronic resource]. – Access mode: http://www.ecb.int/ecb/legal/pdf/en_statute_from_c_ 11520080509en02010328.pdf

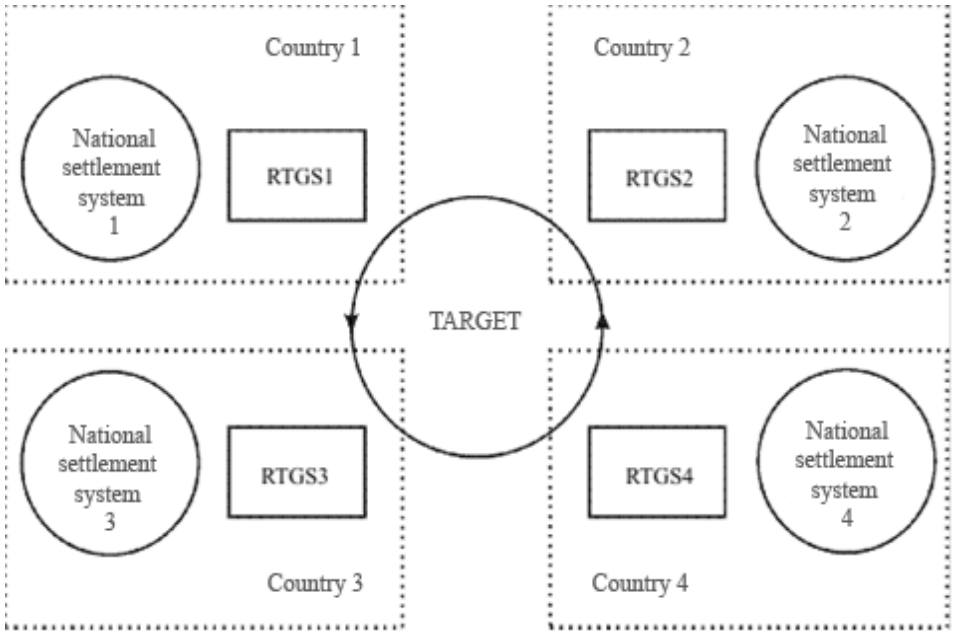

Fig. 1 Interconnection of the bank settlement systems

Source: *Tymchenko M.N.* History of the single European currency introduction and its aftermath /Financial Management, No. 1, 2001 – [Electronic resource]. – Access mode: http://www.finman.ru/articles/2001/1/577.html [In Russian].

Besides, an important role is played by the supranational clearance systems of the European Banking Association – EURO 1 (in fact, being a commercial equivalent to RTGS) and STEP 1 (focused on settlements of small and medium-sized enterprises).

Upon introduction of the euro to the European economic and monetary union currency system the EU territorial enlargement process did not cease: in 2004 and 2007 another 12 states in Europe joined the community, with 6 of them also joining the eurozone: Slovenia in 2007, Cyprus and Malta in 2008, Slovakia in 2009, Estonia in 2011 and Latvia in 2014.

During this process, the same existing convergence criteria applied to new members with compliance extent assessed in accordance with Article 121 of the *Protocol on convergence criteria*. Among other things, it is stipulated that a country must for at least two years apply a new exchange rate mechanism – the so-called ERM-2 (Exchange Rate Mechanism), while its foreign exchange market should not experience too much pressure. The new ERM-2 terms were set forth in the Resolution of the Amsterdam European Council (June 1997) and the Agreement between the ECB and the national central banks of the states outside eurozone (September 1998). It has been provided that

the central exchange rates between the euro and national currencies are established and adjusted by the ECB together with the central banks of the respective countries. Temporary fluctuations are allowed within 15%, whereas upon reaching the latter value national central banks are obliged to ensure unrestricted intervention in the foreign exchange market in order to keep the exchange rate within the prescribed limits. Thus, the new mechanism is quite compatible with a wide range of exchange regulations with exception of only three of those, namely: a) regulation omitting the agreed central exchange rate against the euro; b) 'crawling peg'; c) regulation implying peg to any other currency other than the euro. Attention should without fail be drawn to the fact that a pre-Accession country does have to transit to the fixed euro exchange rate (as a penultimate stage of convergence) and such a country may not during two years of the 'probation term' independently manipulate the exchange rate of its national currency (e.g., in order to enhance competitiveness of domestic producers).

Thus, the European Economic and Monetary Union (or the "eurozone") consists of 18 EU countries. Introduction of the euro has brought them certain advantages. In particular, it should be noted that foreign exchange risk has been eliminated, as were the costs of conversion transactions, while financial markets have become more stable and homogeneous, whereas organizational, technical, legal and regulatory obstacles in the eurozone which used to lead to segmentation and fragmentation of national markets have also been to a large degree done away with.

However, further expansion of the eurozone still remains doubtful. As of January 1, 2015, Lithuania is supposed to join the monetary union. Previously (in 2007), the country was rejected joining the eurozone because of failure to comply with the 'inflation criterion' (by 0.1 %). This time a problem can arise as well, but concerning the 'budget criterion': although the budget deficit is planned at 2.5 % of GDP (which is below the 'access level' of 3%), experts suggest the possibility of an actual deficit increase, which might again jeopardize implementation of the single European currency in Lithuania. Besides, level of support regarding transition to the euro in Lithuania is not high enough[21]. Similar trends are also observed in Poland (which has repeatedly announced its intention of joining the monetary union: first, D. Tusk, the Polish Prime Minister had announced at Krynica 2008 international forum that

[21] *Milne R. , Spiegel P.* Lithuania shows rare enthusiasm for eurozone membership/ Financial Times,Dec/30, 2013 – [Electronic resource]. – Access mode: http://www.ft.com/intl/cms/s/0/ a0ca35e0-54f9-11e3-86bc-00144feabdc0.html?siteedition=intl#axzz2wEBLTN00

Poland would join the monetary union in January 2012, however the term was later shifted to 2014, 2015 and 2016). Today the main problem in this respect implies lack of Seim support to the government, required for introducing changes to the Constitution of Poland which stipulates that the only issuing body of the country is the National Bank of Poland. Provided there is the required majority in the Polish government after the 2015 Parliamentary Elections (at that, political analysts say such an opportunity is most likely to emerge in 2019 at the earliest), all the same experts say that even after introducing the changes for technical and organizational measures on introduction of the euro the latter will have to take at least 6 years. At that, a lot of things could change during this time. Already, two of the three main economic arguments in favour of introducing a single currency (lower loan interest rates and increased foreign investment) have lost their practical value to Poland, whereas the third benefit (reduction of transaction costs) is negated by such a disadvantage as the impossibility of devaluating national currency for boosting international competitiveness of the national economy (which 'peripheral countries' of the eurozone had faced)[22]. However, on the other hand, an important political argument in favour of joining the monetary union emerged: the threat of Russian intervention to Ukraine has forced to ponder over the fact that more integrated countries could expect a higher level of solidarity and protection from their partners. Furthermore, Polish experts believe, closer ties with the eurozone contribute to feeling more confident in the event of an economic crisis, which Russia could cause in Europe[23]. From this point of view, joining the eurozone may prove an additional 'safety lever'.

Joining the eurozone by other 'EU new member states' is primarily restricted by the requirement of prior pegging national currency to the euro. So far, this has been achieved only by Bulgaria. At that, Bulgaria is experiencing significant problems as regards ensuring compliance with criteria for joining the monetary union: in the first place, due to weakness of its public finances (the budget and the debt). Thus, according to P. Chobanov, the Bulgarian Finance Minister, Bulgaria will join the eurozone 'at the appropriate time', as soon as the national economic situation grows favourable. However, experts say it is likely to happen after four

[22] „Poland did not join the euro zone" Puls Biznesu, 06 Lut.,2014 – [Electronic resource]. – Access mode: http://www.pb.pl/ 3548621,26036,polska-nie-wejdzie-do-strefy-euro [In Polish].

[23] *Kamińska A.* Russia pushes us towards the euro / Rzeczpospolita, Mar.5, 2014, s.1 – [Electronic resource]. – Access mode: http:// www.ekonomia.rp.pl/artykul/1091553.html?print=tak&p=0 [In Polish].

years at the earliest[24]. Somewhat more optimistic is the perspective of the Romanian neighbours: according to V. Ponta, the Prime Minister, the country can join the economic and monetary union in 2018-2020[25]. Naturally, a more preferred term would be 2018 – just in time to celebrate the 100th anniversary of the independence of Romania. According to M. Singer, the President of Czech National Bank, introduction of the single currency by the Czech Republic is also planned around this period. However, for the time being this is not regarded as a priority by the government. V. Orbón, the Prime Minister of Hungary, said the government had no plans whatsoever as to introduction of the euro (in his opinion, such plans are unlikely to be conceived in the next two or three decades).

We can conclude that the most efficient argument is the emotional one: a EU Member State which has not introduced the single currency would remain a minor member, as the 'eurozone is where the heart of Europe beats'. However, the 'old Europe' countries outside the euro circulation area (Great Britain, Denmark, Sweden) show no desire of joining the monetary union. In fact, Great Britain is known to have expressed intention of withdrawing from the European Union. In peripheral countries (PIIGS), there also were calls for withdrawal from the eurozone (especially, in Greece). Although, according to observers such calls would not entail serious political consequences, they still do not yield much enthusiasm for further development of the monetary union.

Conclusions

Thus, all the facts indicate that currently the European Monetary Union has exhausted its energy for development along previously assigned trajectory and reached the bifurcation point, whereas its further improvement (possibly, subject to a confederal political structure) or gradual preservation and decline depend upon the direction in which the point is passed.

Most probably, changes in the EU political (elections and establishment of a new European Commission) and economic (establishment of fiscal and banking unions) systems in 2014 will not allow the monetary union to remain in limbo for too long.

---

[24] AFP: Bulgaria like the euro /Vseki Den.com,28/12/2013 – [Electronic resource]. – Access mode: http://www.vsekiden.com/145127 [In Bulgarian].

[25] *Popescu V.* Victor Ponta: A realistic target for Romania's entry into the euro area is 2018 – 2020/ Mediafax, 19 nov 2013 – [Electronic resource]. – Access mode: http://www.mediafax.ro/ politic/victor-ponta-o-tinta-realista-pentru-intrarea-romaniei-in-zona-euro-este-2018-2020-11705984 [In Romanian].

References

1. *Apel E.* European Monetary Integration : 1958 – 2002 – Routledge, 1998, p.68
2. Cigpapers. Latin Monetary Union 1865 t0 1927/ Web:The British National Party, 04.04.2013 [Electronic resource]. – Access mode: http://www.bnp.org.uk/news/national/latin-monetary-union-1865-1927
3. *Danescu E.* 'The Werner Report and the Delors Report', in A rereading of the Werner Report of 8 October 1970 in the light of the Pierre Werner family archives – Conclusion/ Sanem: CVCE, 2012, p.3 – [Electronic resource]. – Access mode: http://www.cvce.eu/content/publication/2012/4/5/72dae01a-6f2f-4b00-8caa-ba66db14d cac/ publishable_en.pdf
4. *Dyson K.,* Featherstone K., The Road to Maastricht. Negotiating Economic and Monetary Union. – Oxford University Press, 1999
5. *Dyson K.,* Elusive Union: The Process of Economic and Monetary Union in Europe - London: Longman, 2004; Dyson K., Featherstone K., The Road to Maastricht. Negotiating Economic and Monetary Union - Oxford University Press, 1999
6. *Eichengreen B.* The European Payments Union : History and Implications for the Evolution of the International Financial Architecture /OECD Development Centre, Paris, March 2001- [Electronic resource]. – Access mode: http://www.jbmacedo.com/oecd/triffin.html
7. *Essars P. de, Raffalovich A., Walker B. E.* A History of Banking in all the Leading Nations, vol. 3 (France, Italy, Spain, Portugal, Canada), part VIII: The Latin Monetary Union/The Online Library of Liberty [Electronic resource]. – Access mode: http://oll.libertyfund.org/?option=com_staticxt&staticfile=show.php%3Ftitle=2239& chapter=212158&layout=html&Itemid=27
8. *Geyer M.* One Language for the World: The metric System, International Coinage, Gold Standard, and the Rise of Internationalism, 1850-1900/ In: The Mechanism of Internationalism, Oxford University Press, 2001
9. *Gros D., Thygesen N.,* European Monetary Integration. From the European Monetary System to Economic and Monetary Union - London: Longman, 1998
10. *Kawalec S., Pytlarczyk E.* Controlled dismantlement of the Eurozone: A proposal for a New European Monetary System and a new role for the European Central Bank/ National Bank of Poland, Working Paper No. 155- Warsaw, 2013
11. *Lastra R.M.* Ch 6: History of monetary integration in Europe / In: The Legal Foundations of International Monetary Stability - Oxford University Press, 2006
12. *Mundell R.*, "A Theory of Optimum Currency Areas." American Economic Review, № 51, 1961, pp.657- 665

13. *Nikolaichuk S., Khomyak V.* Eurozone crisis: result of lacking fiscal discipline or accumulation of external imbalances? / Bulletin of the National Bank of Ukraine, No. 2, 2013 [In Ukrainian].

14. *Nordvig J., Firoozye N.* Rethinking the European monetary union/ Wolfson Economics Prize 2012 - Final submission

15. Regulation (EEC) No 907/73 of the Council of 3 April 1973 establishing a European Monetary Cooperation Fund/ Official Journal of the European Communities 05.04.73, pp. L 89/2-3 – [Electronic resource]. – Access mode: http://ec.europa.eu/economy_finance/emu_history/documentation/chapter6/19730403en04euromonetcoopregul.pdf

16. *Rolnik A., Velde F., Weber W.* The Debasement Puzzle: An Essay on Medieval Monetary History / The Federal reserve Bank of Minneapolis, Working Paper 536, Sept.,1995. – [Electronic resource]. – Access mode: http://www.minneapolisfed.org/research/wp/wp 536.pdf

17. *Talia K.* The Decline and Fall of the Scandinavian Currency Union 1914 – 1924 – Events in the Aftermath of World War I. Stockholm School of Economics. – [Electronic resource]. – Access mode: http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.195.6778&rep=rep1&type=pdf

18. *Tymchenko M.N.* History of the single European currency introduction and its aftermath /Financial Management, No. 1, 2001 – [Electronic resource]. – Access mode: http://www.finman.ru/articles/2001/1/577.html [In Russian]

19. *Ungerer H.* A Concise History of European Monetary Integration: From EPU to EMU, 1997.

20. *Vaknin S.* Deja V-Euro. The History of Previous Currency Unions/ – [Electronic resource]. – Access mode: http://samvak.tripod.com/nm032.html

The article was received by the editorial board on 07.02.2014