2 The Path to European Monetary Union

► Since the irrevocable fixing of exchange rates of eleven European countries on the 1st of January 1999, the euro has become the official currency for 330 million people and the GDP of today's 17-country eurozone adds up to almost EUR 9.5 trillion (2012), ranking second behind the United States. As a project of monetary integration, the euro is without historical precedent. Its governance is complex and unique. Its evolution is embedded in the history of Europe. While many early proposals for a common European currency were fuelled by the idea of political unity, the first concrete steps towards the Monetary Union actually had the economic objective to limit exchange rate fluctuations and to stabilize monetary relations. This became all the more important after the end of the fixed exchange rate system of Bretton Woods and the large swings of the US dollar on exchange markets. This chapter examines very briefly how the idea of a single currency was born and what steps led to today's euro (Fig. 2.1)[1].

As can be seen on the websites of the EU Commission, an early mention of a single European currency dates back as far as 1929. It was Gustav Stresemann, then foreign minister of Germany, who put the following question to the League of Nations on the 9th of September 1929: "Where are the European currency and the European stamp that we need?" (European Commission 2012a). Stresemann complained about the frontiers that had been created through the Treaty of Versailles and that these impeded easy travel and trade across Euro-

[1] For thorough and comprehensive historical analyses see: James (2012) and Marsh (2009). Additional information can also be found in: Baldwin and Wyplosz (2009) and European Union, EU (1995–2012).

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Date	A synopsis of events that led to the Euro
18-Apr-51	**Treaty of Paris:** Establishment of the **European Coal and Steel Community (ECSC)** by Belgium, France, Germany, Italy, Luxembourg and the Netherlands
25-Mar-57	**Rome Treaties:** Foundation of the **"European Economic Community"** (EEC) and the **"European Atomic Energy Community"** (Euratom)
12-Feb-69	**Barre report:** A memorandum to the Council calls for progress in economic policy coordination and monetary cooperation within the Community
2-Dec-69	At the **summit conference in Den Haag,** the Heads of State or Government state their commitment to deepen and enlarge the community. They agree on the goal of creating an **economic and monetary union** and decide that a "plan in stages" should be worked out during 1970
6-Mar-70	Finance Ministers of the Six Member States discuss Economic and Monetary Union in Paris and assign an expert-committee with **Pierre Werner** as chair to work out a plan for achieving economic and monetary union.
13-Oct-70	Submission of the final draft of the "**Werner Report"** to the Council and the Commission with a plan to achieve the targeted economic and monetary union in stages by 1980
22-Mar-71	**The Council formally approves** the recommended actions of the Werner group necessary to attain by stages an economic and monetary union, to strengthen the coordination of short-term economic policies as well as the cooperation between central banks
15-Aug-71	Unilateral closing of the **gold window** and abolition of the dollar's convertibility by US president Nixon
10-Apr-72	**Basel Agreement** to narrow the margins of fluctuation of currencies. Creation of the "**snake in the tunnel"**
12-Mar-73	The Council declares the **suspension of the need for central banks to intervene** in the fluctuation margins of the US dollar to maintain the maximum variance of 2.25% between the member states' currencies
3-Apr-73	Establishment of the **European Monetary Cooperation Fund (EMCF)**
March 73	Major currencies begin to **float freely** against each other
1-Jan-74	**Denmark**, **Ireland** and **the United Kingdom** join the European Economic Community
7-Jul-78	**Bremen European Council:** Agreement on the broad lines of a **European Monetary System (EMS)**, such as the participation of all currencies of the European Community and open to participation by other currencies, the **European Currency Unit (ECU)** as pillar of the system, rules at least as strict as the "snake" and the replacement of the EMCF with a European Monetary Fund
13-Mar-79	The **European Monetary System (EMS)** starts to operate with central rates in ECUs and intervention rules.
24-Sep-79	Currencies within the EMS are **realigned for the first time.** The realignment includes a 2% revaluation of the German mark and a 3% devaluation of the Danish krone against all the other EMS currencies
1-Jan-86	**Portugal** and **Spain** join the European Economic Community
1-Jul-87	The **Single European Act** enters into force
22-Jun-88	The European Council passes a Directive on the **complete liberalisation of capital movements** by 1 July 1990 and allows derogations for Spain, Greece, Ireland and Portugal until the end of 1992
28-Jun-88	In Hannover, the **European Council assigns** a committee with **Jacques Delors** as chair with the task of drafting a proposal for concrete stages leading towards economic and monetary union
1-Apr-89	**Presentation of the Delors Report** on economic and monetary union in the European Community
19-Jun-89	The **Spanish peseta** and the **Portuguese escudo** are added to the ECU

Fig 2.1 A synopsis of events that led to the euro. (http://ec.europa.eu/economy_finance/emu_history/legalaspects/part_c_1.htm)

1-Jul-90	**Start of the first stage of EMU including** the implementation of decisions on multilateral surveillance (objective of economic convergence) and on strengthening the task and role of the Committee of Central Bank Governors (monetary cooperation); completion date for the total liberalisation of capital movements for eight Member states; Spain, Greece, Ireland and Portugal have derogations until the end of 1992 or 1995
10-Dec-91	**The Maastricht European Council** takes decisions on revising the existing Community Treaties with the special objective for EMU and an independent **European Central Bank** with the right to issue a **single currenc**y and of making advances in the fields of economic policy and budgetary policy and discipline at the Community level.
7-Feb-92	The **Treaty of Maastricht** on the European Union is signed
13-Sep-92	**Devaluation of the Italian lira** by 7% against all the other EMS currencies participating in the exchange-rate mechanism (ERM)
16-Sep-92	**Black Wednesday:** The British pound sterling withdraws from the ERM after it was unable to stay above the lower limit due to speculations against it
29-Oct-93	Decision by the **European Council** to start the **second stage of EMU** on 1 January 1994 and to locate the European Monetary Institute in **Frankfurt/Main**
1-Nov-93	**Legal ratification of the European Union with the Maastricht Treaty**. The Maastricht Treaty formulates rules for the second and third stage of EMU. The composition of the ECU basket is "frozen"
22-Nov-93	Procedure for the **case of an excessive budgetary deficit** in a Member State is adopted by the Economic and Financial Affairs Council
1-Jan-94	**The second stage of EMU** starts, which also means the launch of the European Monetary Institute.
1-Jan-95	**Austria, Finland and Sweden** join the European Union. The Austrian Schilling joins the ERM
16-Dec-95	**The Madrid European Council names** the single currency **"euro"** and sets the technical scenario for embarking on the third stage of EMU
14-Nov-96	The **Dublin European Council** determines the future structure of **an exchange-rate mechanism (ERM2)** with those EU currencies not in the euro area and agrees on the key principles and elements of the Stability and Growth Pact for ensuring budgetary discipline in EMU
17-Jun-97	The **European Council in Amsterdam** approves, among others the resolution on the Stability and Growth Pact, a resolution on growth and employment and on the establishment of an exchange-rate mechanism in the third stage of economic and monetary union (ERM2)
2-Oct-97	The Member Countries sign the **Treaty of Amsterdam**, which completes the Treaty on European Union signed at Maastricht in 1992
17-Nov-97	**January 1 2002 is** fixed as the date for the introduction of euro coins and banknotes
15-Mar-98	The **Greek drachma** enters into the exchange-rate mechanism (ERM) of the EMS
30-Apr-98	The **European Parliament** welcomes the introduction of the single currency by 11 Member States that have fulfilled the requisite conditions
3-May-98	Final confirmation by the **Council** that 11 Member States fulfil the requirements for the adoption of the single currency on 1 January 1999. Determination of the bilateral central rates which will be used in determining the final conversion rates for the euro
26-May-98	The **Heads of State or Government** of the participating Member States appoint **Wim Duisenberg** as President of the ECB for eight years and decide on the further members of the ECB's Executive Board
1-Jun-98	Start of the **European Central Bank in Frankfurt** Which replaces the European Monetary Institute. The ECB administers the European System of Central Banks, which is responsible for maintaining price stability. Furthermore, the ECB implements the common monetary policy, conducts foreign-exchange operations and manages the official foreign-exchange reserves of the Member States
4-Jun-98	First meeting of the **"euro-11"** group
31-Dec-98	**Conversion rates** between the euro and the currencies of the eleven Member States adopting the single currency are irrevocably fixed

1-Jan-99	**Start of the third stage:** Introduction of the euro as a currency on its own on the international exchange markets. The first rate of the euro to the USD is 1,18 USD=1 EUR
9-Mar-00	**Greece applies** to join third stage of EMU
20-Jun-00	The European Council ratifies **Greece's entry** into the eurozone as of **1 January 2001**
1-Jan-02	**Physical introduction of euro banknotes and coins**
1-May-04	**Eastern Enlargement of the EU** - Estonia, Latvia, Lithuania, Malta, Poland, Slovenia, Slovakia, Czech Republic, Hungary and Cyprus join the European Union
1-Jan-07	**Bulgaria and Romania** join the European Union
1-Jan-07	**Slovenia** joins the eurozone
1-Jan-08	**Cyprus** and **Malta** join the eurozone
1-Jan-09	**Slovakia** joins the eurozone
1-Jan-11	**Estonia** becomes member of the eurozone

Coloration

Third attempt - First stage
Third attempt - Second stage
Third attempt - Third stage

Fig 2.1 (continued)

pean borders. While these words and ideas were exceptionally visionary for the time Europe was set to see its darkest chapter only a few years after Stresemann had delivered this speech. However, the tragedy of the Second World War ultimately led to the foundation of three European institutions, which would later evolve into the European Union and pave the way for the creation of the euro. Six countries—Belgium, France, Germany, Italy, Luxembourg and the Netherlands—established the European Coal and Steel Community (ECSC) on the 18th of April 1951. In March 1957, the Rome Treaties between these countries laid the foundation for the creation of the "European Economic Community" (EEC) and the "European Atomic Energy Community" (Euratom). Due to the existence of the Bretton Woods System, monetary coordination was at first not the focus of the EEC, but rather emerged as an idea when the Bretton Woods System began to fall apart at the seams. Efforts to promote monetary integration can be broken down into three broad attempts. These provide a guideline for understanding the course of events:

- The first attempt was initiated by the Barre Report in 1969, aimed at achieving an Economic and Monetary Union. While this first initiative failed, it marks the beginning of efforts towards monetary and economic integration and provided lessons for subsequent attempts.
- The second attempt followed in 1979 with the creation of the European Monetary System (EMS) and the European Currency Unit (ECU).
- The third attempt, which would later lead to the introduction of the euro, was started by the "report on EMU in the European Community" by the Delors Committee in 1989 (European Commission 2012b).

Before these attempts, the European Council had in 1964 decided that central banks of the Member States of the EEC should cooperate, especially in the field of international monetary relations and that Member States should consult prior to changes in exchange-rate parities. At the December 1969 summit in The Hague, the Heads of State and Government agreed on the basis of the Barre report upon a new objective of European integration, namely an Economic and Monetary Union (EMU). They assigned a group, headed by Pierre Werner, the Prime Minister of Luxembourg, with the task of drafting a report on how to achieve this by 1980. The reasons for the EEC countries to seek monetary stability and monetary cooperation were manifold. For relatively small and open European economies, the exchange rate was an important variable, since highly volatile nominal exchange rates created negative effects on trade and investments in the form of high uncertainty and hedging costs. As intra-European trade relations became stronger, exchange rate volatility was seen as a barrier to trade and made it difficult to handle integrated value chains. The Bretton Woods System of dollar pegs ran into trouble in the late 1960s and the European countries were keen to become more independent from monetary policies in the United States. The continuous devaluation of the dollar and expansionary policies to finance the Vietnam War increasingly conflicted with European interests. For these reasons, the Member States of the EEC considered the creation of a monetary zone as a viable option to achieve more monetary independence and stability.

In its final report, submitted in October 1970, the so-called "Werner Group" set out a plan to achieve the targeted economic and monetary union in stages by 1980. While the adoption of a single European currency was seen as a long-term outcome of the process, primary goals were the complete liberalisation of capital movements, the full convertibility of countries' currencies and the fixing of exchange rates. In order to achieve these targets, the Werner Group called on Member States to improve economic policy coordination and to draft rules for national budgets. The Member States approved the recommended actions by the Werner Group, but willingness to follow through with concrete steps was wanting. The Werner Plan finally collapsed under the financial turmoil that was about to set in. In August 1971, the United States unilaterally closed the gold window and announced the dollar's non-convertibility with respect to gold. The resulting devaluation inflicted losses on US dollar holders and the final breakdown of the Bretton Woods system in 1973 disrupted plans for monetary union in Europe. This tremendous change in the exchange rate system caused instability on foreign exchange markets and put severe stress on the parities between the European currencies. Rising oil prices added further pressure and triggered a broad range of different policy responses by the member countries.

In March 1972, the six founding members of the EEC had decided to collaborate in order to stabilize exchange rates by creating the "snake in the tunnel" and establishing the European Monetary Cooperation Fund (EMCF) in 1973. The "snake in the tunnel" mechanism was designed to have Member States' currencies float within a certain range against the dollar. It pegged the EEC currencies against each other and was intended to stabilize inner-European trade relations. It was joined by the newly acceded member countries United Kingdom, Denmark and Ireland. The "tunnel" defined specific margins of fluctuation against the dollar, while the "snake" was the managed floating of the currencies around the dollar within these margins. The prevailing weakness of the dollar, different approaches in economic policy by the member countries and the oil crisis soon led to the demise of this scheme and the exit of nearly all members within 2 years. It was the lack of monetary discipline and the preference for stimulating growth and employment that made countries join and leave the Economic Monetary System, whichever they regarded as more valuable in each situation. France, for example, left the system twice—in 1974 and again in 1976 after it had temporarily rejoined. Italy and Sweden also preferred to go their own ways. Since even the first stage could not be completed successfully, the second and third stages of the Werner Plan had died. While first the "tunnel" had faded due to the free floating of the dollar after the abolition of the gold standard in 1971, the "snake" did not survive either as Member States did not stick to it. The consequence was a currency area with the German "mark" as anchor currency and especially smaller countries (like Denmark and the Benelux) following the monetary policy of the German Bundesbank, which had proven its independence from political interests and its monetary stability credentials.

Initiated by France and Germany in the persons of Giscard d'Estaing and Helmut Schmidt, the second attempt to finally create an economic and monetary union with stable exchange rates was launched in March 1979 with the creation of the European Monetary System (EMS). The European Council had agreed upon the broad outlines of the EMS in July 1978 and decided that it should comprise all the currencies of the EEC and that it should be based on a European Currency Unit (ECU) as a pillar of the system. Furthermore, the new set-up foresaw fixed, but adjustable exchange rates with rules that should be at least as strict as the "snake". While it was also designed to create and maintain monetary stability, it additionally aimed at achieving closer economic convergence between Member States. Except for the UK, all the Member States participated. The ECU was created to serve as a benchmark for calculations of exchange rates for a newly created credit mechanism between the Member States and it was intended to replace the German mark at least symbolically as the political currency of Europe. The ECU itself was a weighted average of the participating currencies, with the mark initially accounting for 33 % and the franc for 20 % of this virtual basket currency. Currencies were allowed to fluctuate within a margin of 2.25 % to either side of bilateral rates based on the calculation of the ECU. Italy was given a margin of 6 %. Intervention rules were based on these bilateral rates, not on the central parities to the ECU. The system soon came under stress, when the second oil price shock in 1979 created upward pressure on inflation and led to restrictive policy moves by the Deutsche Bundesbank, which all other EMS members more or less had to follow in order to keep their exchange rates within the narrow bands. The increasing tensions led to numerous exchange rate adjustments in the years up to the early 1990s. Despite these problems, the creation of the EMS can be seen as the turning point in European monetary integration.

Parallel to closer monetary integration, the EU Council adopted the Single Market Programme in 1985 and the Single European Act 1987, under which a market without internal frontiers was to be completed by 1992. In June 1988, the European Council passed a directive for the complete liberalization of capital movements and committed to the target of a step-wise realisation of the economic and monetary union. It assigned a committee comprising the governors of the national central banks and Jacques Delors—then president of the European Commission—as chair with the task of analysing and suggesting concrete steps towards the realization of such a union. The resulting "Delors Report" proposed an economic and monetary integration in three stages. It was publicly released in April 1989 and accepted by the Madrid European Council in June 1989. This is important, as Germany's agreement to the euro is often said to have been the price for German unity paid by the Kohl government. Actually at the time of the Delors report, the possibility of reunification was not yet foreseeable, so the argument has been rejected by many policymakers of that time. But on the other hand, the international treaties for the euro had to be worked out in the years following the Delors report and the German position in these negotiations was certainly influenced by reunification. The creation of the euro was a signal to all partners that the reunified Germany—sacrificing its D-mark, a symbol of economic success and a part of German identity—would be an integral and inseparable part of Europe.

In 1989, the European Commission launched the first stage by implementing measures to eliminate all restrictions on the free movement of capital by July 1990, as outlined in the Delors Report. For the second and third step, however, a new institutional framework was needed. For this purpose, the European Council enacted an intergovernmental conference in December 1989 with the aim of identifying what Treaty amendments were needed in order to provide the legal framework for the final implementation of the EMU. Governments convened in 1991 and negotiated the economic, monetary as well as the political union. This process finally resulted in the Treaty of Maastricht on the European Union, adopted by the Heads of State and Government in December 1991, signed on February 7th 1992 and finally ratified on November 1st 1993. This paved the way for the European System of Central Banks, the foundation of the European Central Bank (ECB) in 1998 and the definition of its task. The Treaty of Maastricht planned to fix exchange rates for a common currency in a third stage—at the latest in 1999. Participation in the final process of introducing the currency required among other things compliance with two criteria for budget stability: budget deficits were not to exceed 3 % of GDP even in periods of weak economic activity and public debt was not to exceed the threshold of 60 % of GDP. Further convergence criteria asked for inflation rates of at maximum 1.5 % points higher than the average of the three most stable countries, long-term interest rates not more than 2 % above the average of the three lowest interest-rate countries and for no tensions in the exchange rate mechanism for at least 2 years before the introduction of the common currency.

Before the second stage could begin, however, the new exchange-rate mechanism (ERM) and the European Monetary System had to weather a further crisis in 1992. The repercussions of German reunification and high German interest rates destabilized the ERM, since the restrictive monetary policy of the German Bundesbank was not suited for the other member countries. Italy was grappling with declining economic activity as well as fiscal problems and by mid-September 1992 it had become clear that the current parity of the lira was no longer sustainable. On September 13th, the Italian lira was devalued by 7 %. However, the lira immediately reached its new ERM floor again the next day, while the British pound also came under increased stress due to mounting speculation. On September 16th, subsequently known as Black Wednesday, the British pound fell below its lower ERM bound and consequently the Bank of England announced sterling's withdrawal from the ERM. On the same day, Italy decided not to intervene anymore and left the ERM. The crisis exposed the vulnerability of the ERM and later on resulted in the adoption of a new adjusted exchange-rate mechanism (ERM II) and the widening of intervention bands to 15 %.

During the second stage from 1994 to 1998, the European Monetary Institute (EMI) inherited the tasks from the former EMCF and the Committee of Governors. It was responsible for enabling and strengthening cooperation among national central banks and coordination of monetary policies, but had no monetary competencies of its own. Basically, it was supposed to build the foundations for the implementation of a common monetary policy, targeting price stability and the creation of a single currency later during the third stage. Converging economic policies were one essential step towards achieving this goal. Furthermore, the national central banks had to become independent before stage three could begin. In December 1995 the EMI decided to name the single currency "euro", which was to be introduced with the onset of the third stage on January 1st 1999. As early as in December 1996 it presented to the public the designs for the euro notes, which would be brought into circulation on January the 1st, 2002.

At the Madrid Council meeting in 1995 the decision was taken to enter into the third stage with irrevocably fixed exchange rates in 1999. German demands were accepted to supplement the Maastricht treaty with a Stability and Growth Pact which was then drafted and eventually passed in June 1997. It was designed to ensure fiscal discipline in the economic and monetary union's Member States. The pact was amended and finally ratified in May 1998. However, as early as in February 1996, the European Parliament had decided that "in the case of an excessive deficit of a Member State (…) the general economic position must be taken into account", making the 3 % rule more flexible, but also susceptible to arbitrariness (European Commission 2012c). This was an early sign that the Stability and Growth Pact might prove not to be as effective as intended (see Sect. 6.1).

On May 2nd 1998 the Council of the European Union announced that eleven Member States fulfilled the requirements for participation in the third stage and thus, for the introduction of the common cur-

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