# EU Monetary Union

## 1. History of the EU Monetary Union
## 2. Convergence and Single Monetary Policy
## 3. Eurozone, Eurogroup, Eurosystem, ECB
## 4. Maastricht Stability and Growth Pact
## 5. Fiscal Compact and EU Banking Union

### 1.A) The Bretton Woods System

**The Bretton Woods System (1944 – 1971) was created during the 1944 United Nations Monetary and Financial Conference**

**The three rules (pillars) of the system:**

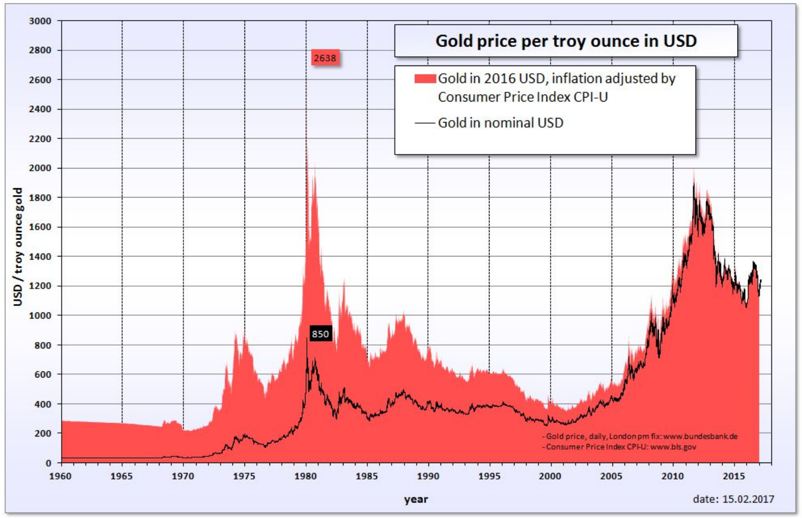
✓ **All currencies have fixed rates against the dollar and can change them (revaluation or devaluation) only with the permission of the IMF.**

✓ **The U.S. dollar has a fixed price in gold = 35 dollars per ounce (gold - dollar standard) (1 ounce = 28.3495231 grams, 1 USD = 35/28.35 g AU = 0.81 g AU).**

✓ **The central banks of the IMF Member States hold their reserves mostly in dollars and can replace them where they decide against gold from the USA reserve system.**

**But due to the large balance of payments deficits (Vietnam War) in the late 60's and early 70's USA gradually lost their gold. While in 1963 it was equal to their duties to other central banks, in 1970 it was equal to only 50% of them, and in 1971 - only 22%.**

**USA attempted to limit the leak of gold from their country, but failed. On 15.8.1971 President Nixon closed the Golden Window. He performed the first unregulated by the IMF devaluation of the dollar by 8.5 percent. The price in dollars of one ounce gold increased from 35 to 38 dollars. This means that the so called gold content of 1 U.S. dollar fell from 0.81 g gold to 0.75 g. Next unregulated devaluations followed.**




## B) The Werner Plan (1969) and the Basel Agreement

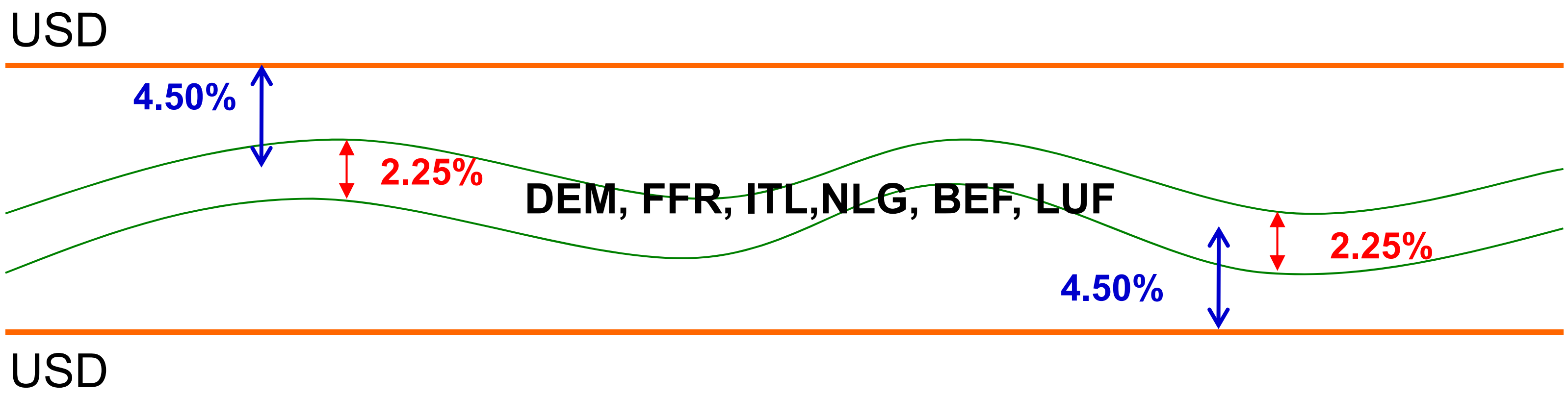
- **After collapse of Bretton Woods System began the era of „free floating“ of the currencies.**
- **At the European Summit in The Hague in 1969 Heads of State and Government of the EEC agreed to adopt a plan for Economic and Monetary Union (EMU)! The Werner Report for creating EMU was drawn up by a working group chaired by Pierre Werner, Luxembourg's Prime Minister and presented to the EEC Member States in 1970.**
- **The three-stage plan proposed gradual, institutional reform leading to the irrevocable fixing of exchange rates and the adoption of a single currency within a decade, though it did not re-commend the establishment of a Central Bank. The plan was never implemented, due to pressure of the USA and after Charles de Gaulle's resignation in 1969.**

**“Snake in the Tunnel” (1972 г.) or The Basel Agreement of the EEC Member States**

- **The Snake – 2.25% allowed fluctuations of EEC daily currency exchange rates around authorized central bilateral exchange rates (for greater deviation a permission was needed). Bilateral interventions to prevent collapse of the snake.**

- **The Tunnel – An European computational unit (ECU) is created, representing a "basket of currencies. Daily allowed deviation of the ECU from an authorized central exchange rate against the dollar – 4.5%. If there are greater than permitted deviations a collective intervention is necessary. For this purpose, a special multilateral intervention fund was created.**

- **The oil crisis in 1974 put and end to the challenge. First the snake collapsed and then the rest of the snake left the tunnel. First left the snake (ECU) the Britons, who had just joined the EEC!**



## C) European Monetary System

In the late 1970's the situation on the financial markets had calmed down. The idea of an European monetary union was resumed. In 1979, as a first step towards the monetary union was created the European monetary system (EMS).

**EMS is based on the following rules:**

1. "The Snake" was replaced by the European Exchange Rate Mechanism (ERM). Currency fluctuations similar to the Basel Agreement had to be contained within a margin of 2.25% on either side of the fixed bilateral exchange rates (with the exception of the Italian lira, which was allowed a margin of 6%). In the early 1990's, there was a crisis in the ERM. The United Kingdom and Italy left ERM. In 1993, the allowed margin was increased to 15%. In 1994, the markets calmed down again and the margin returned to its original value of 2.25%. Stand-by agreements between central banks successfully maintained bilateral courses through joint interventions.

2. The European computational unit was replaced by the European Currency Unit – ECU. The exchange rate ECU to USD was estimated again by the value of a "basket of currencies". An European Monetary Cooperation Fund (EMCF) was created. 20% of the national gold and foreign currency reserves of the EMS Member States had to be placed under the authority of the EMCF. The main task of the EMCF was to intervene on the global financial markets in order to support the ECU international value (primary against USD).

3. The EEC budget was calculated in ECU and payments under EEC projects were also estimated in ECU. In the late 1990's it was already possible to open a bank account in ECU.

Price of the ECU in the currency j **(USD)**

$$S_j = \sum_{k = 1 \ldots 12} q_k . sk_j$$

where:

**$q_k$ is the participation of the national currency k in the ECU "basket"**

**$sk_j$ is the price of the national currency k expressed in the currency j (USD)**

| Currency | $q_k$ | $sk_j$ | $q_k.sk_j$ |
|---|---|---|---|
| BEF | 3,301 | 0,0980 | 0,323627 |
| DEM | 0,6242 | 0,3030 | 0,189152 |
| DKK | 0,1976 | 0,0595 | 0,011762 |
| ESP | 6,885 | 0,0231 | 0,159375 |
| FRF | 1,332 | 0,1220 | 0,162439 |
| GBP | 0,08784 | 1,4925 | 0,131104 |
| GRD | 1,44 | 0,0078 | 0,011215 |
| IEP | 0,008552 | 0,0806 | 0,00069 |
| ITL | 151,8 | 0,0009 | 0,141869 |
| LUF | 0,13 | 0,0980 | 0,012745 |
| NLG | 0,2198 | 0,2500 | 0,05495 |
| PTE | 1,393 | 0,0179 | 0,024875 |
| | | $S_j$ | 1,223803 |

**EU Monetary Union was built in 4 stages:**

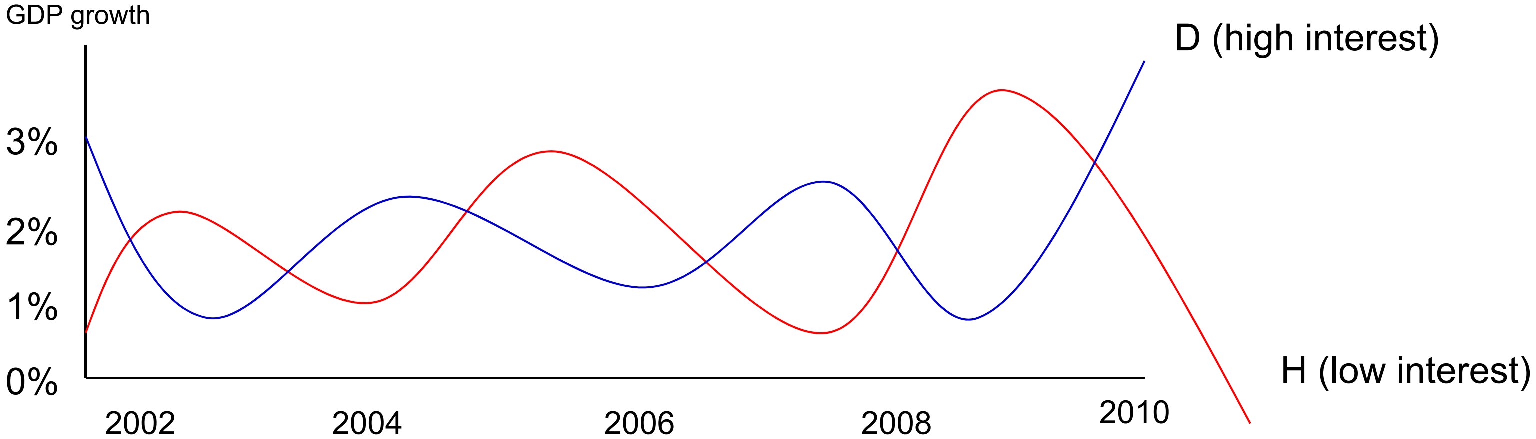
**First stage 01.01.1994 – May 1998**
– European Monetary Institute (EMI)
– Annual convergence reports

**Second stage May 1998 – 01.01.1999**
– Social and economic preparations for the introduction of the euro

**Third stage 01.01.1999 – 01.01.2002 г.** - Minting, printing money
**Fourth stage 01.01.2002 - 01.07.2002** - Coexistence between the euro and national currencies

## 2. Convergence and Single Monetary Policy

Interest rate policy of the central bank depends on the development of the economic cycle (GDP)




### EU Monetary Union convergence criteria

**1. Inflation rate criterion: No more than 1.5 percentage points higher than the average of the three best performing EU Member States.**

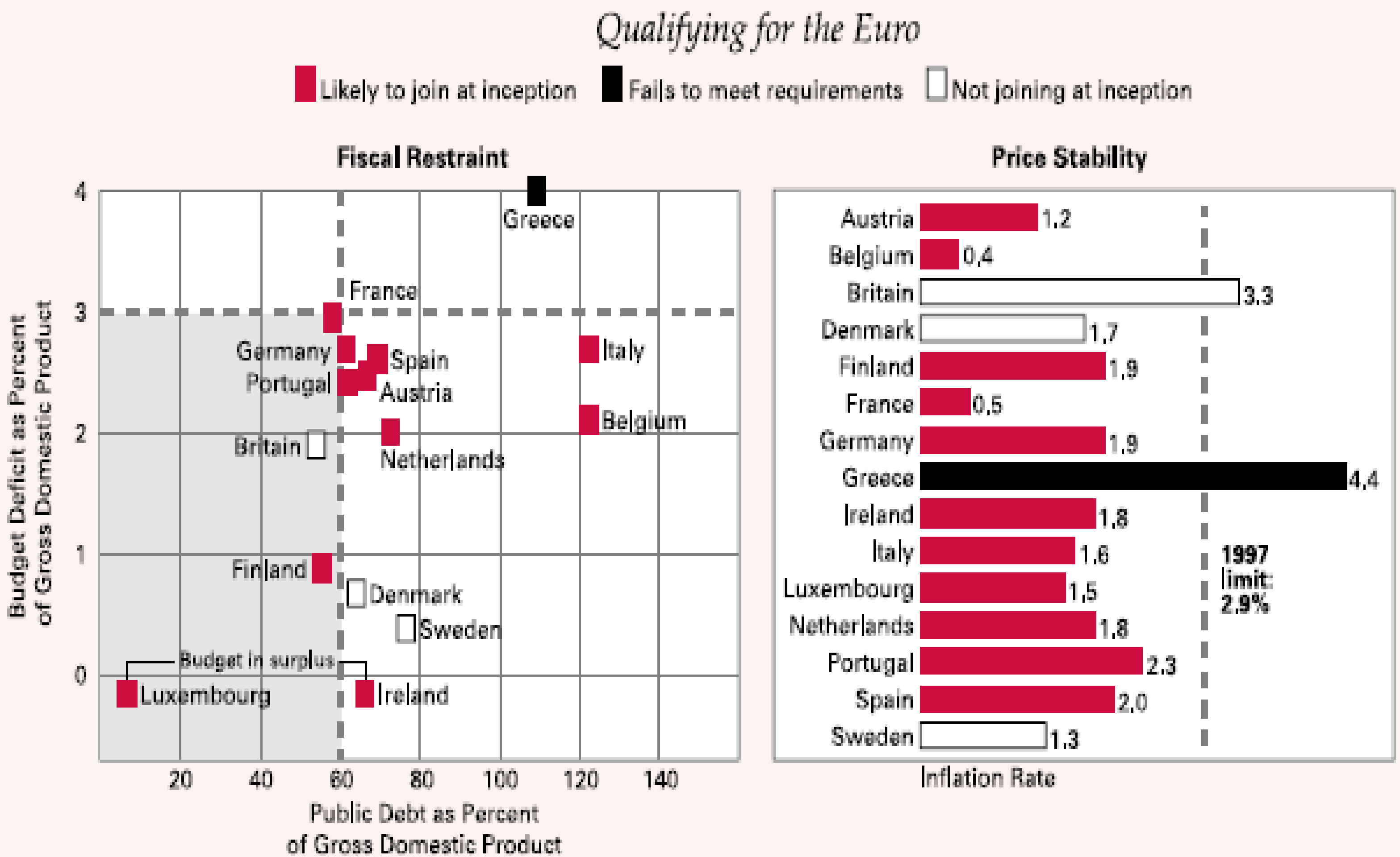
**2. Budget deficit criterion: The ratio of the annual government deficit to GDP must not exceed 3% at the end of the preceding fiscal year.**

**3. Government debt criterion: The ratio of gross government debt to GDP must not exceed 60% at the end of the preceding fiscal year.**

**4. Interest rates criterion: The nominal long-term interest rate must not be more than 2 percentage points higher than in the three Member States with lowest interest rates.**

**5. Exchange rate criterion: Applicant countries should have joined the Exchange-rate-mechanism (ERM) under the European Monetary System for at least two consecutive years and should not have devalued its currency during the period.**

Figure 3




In the first chart, countries below the horizontal dashed line satisfy the budget criterion; those to the left of the vertical dashed line satisfy the debt criterion; those in the gray area meet both requirements.

# 3. Eurozone, Eurogroup, Eurosystem

## a) Eurozone

**In 2017, it consisted of 19 EU Member States. 3 old Member States – UK, Sweden and Denmark are able, but not willing to join the Eurozone and 6 new Member States are temporary outside: Poland, Hungary, Czech Republic, Romania, Bulgaria and Croatia.**

**Not included in the Eurozone are : North Cyprus and the French and Dutch oversees territories. Not included are also: Monaco, San Marino, the Vatican and Andora, which have concluded agreements with the EU permitting them to use the euro and mint coins.**

**Kosovo and Montenegro use the euro without an agreement with the ECB and cannot mint coins.**

## b) Eurogroup

**It is a forum of the finance ministers of the Eurozone Member States. They meet before the meetings of EU Council (Ecofin). Since 2012 its president has been Jeroen René Victor Anton Dijsselbloem – Dutch Minister of Finance (PES). Now the Europgrup has a new president -** the Portuguese Finance Minister Mário CENTENO

**Eurogroup enjoys exclusive rights in the EU Council concerning issues related to the Eurozone.**

## c) Eurosystem & ERM II

- The Eurosystem consists of the European Central Bank and the central banks of the Member States of the Eurozone – now 19. The primary objective is the price stability (inflation below 2%). Secondary objective is the financial stability (sound banking system) and another important objective is the development of the financial integration (Eurozone consolidation – Fiscal Compact).

- The Eurosystem is distinct from the European System of Central Banks, which is the group of central banks that includes the ECB and the central banks of all EU Member States. Goal is to improve monetary and financial cooperation between the Eurosystem and the Member States outside the Eurozone (ERM II). Important objective is also the Eurozone enlargement.

- Currently only 1 country is in the ERM II – Denmark. A currency in ERM II is allowed to float within a range of ±15% with respect to a central rate against the euro. In the case of the Danish Krone the exchange rate is within the range of ± 2.25%.

- EU countries outside the Eurozone have to participate in ERM II for at least two years before joining the Eurozone.

# d) European Central Bank

Mario Draghi – ECB President

- **ECB present monetary policy (interest rate policy)**

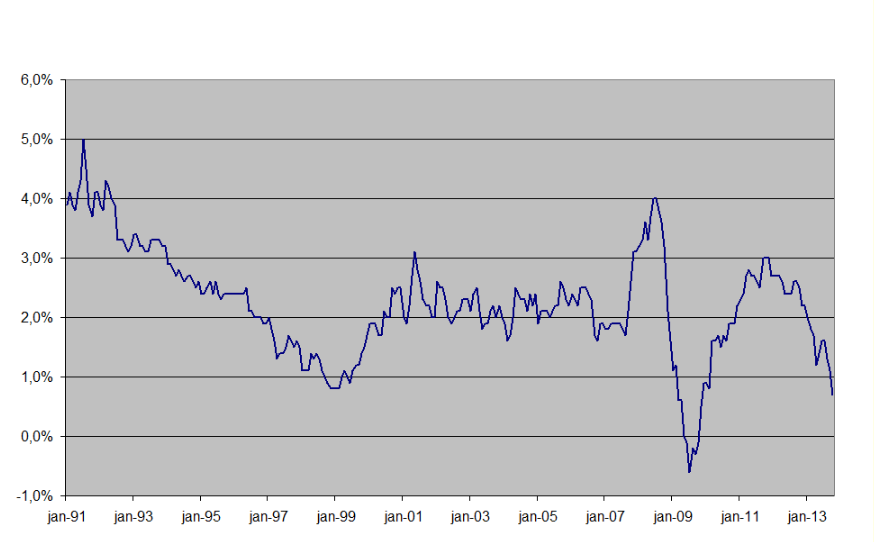
**Main instrument - the interest rate on short-term refinancing of banks in the Eurozone. This is an inherent feature of all central banks. In the current situation in the Eurozone ECB maintains an extremely low interest rate of 0.5 - 1.0%. This is used to stimulate credit and economic growth.**

**Important is what ECB accepts as collateral for loans from the Member States banks government securities (treasury bonds). Over the period 2009 – 2011 through the ECB policy of "easy money" it has granted to private banks in the Eurozone over 800 billion Euro loans secured by treasury bounds mainly from Italy, France and Spain, so called Outright Monetary Transactions – OMT)**

**The main task of ECB is not to allow " the increase in the harmonized index of consumer prices HICP on an annual basis to exceed 2%.“**

**But ECB Easy Money Policy could threaten the price stability in the long term.**

**Q: Why has this not happened yet?**



## 4. Maastricht Stability and Growth Pact

**An Agreement between the Eurozone Member States signed in 1997.**

### A) Grounds

**To avoid differences in fiscal policy lead to differences in monetary policy and hence to an inability to take decisions in the Eurozone**

**To avoid the so called cross-border inflation.**

### B) Basic rules

**The annual general government deficit should not exceed 3% of GDP.**

**The European Commission seeks to incorporate a second basic rule – the government debt not to exceed 60% of the GDP.** It is a very difficult goal because almost all Member States of the Eurozone have a debt above this treshhold.

- **A deviation of the rules can be tolerated in time of economic recession or in some force majeure situations.**
- **Such an exception to the rules should be authorized by the EU Council (Ecofin) based on the Commission's opinion.**
- **European Commission is monitoring the budget policy not only of the Eurozone Member States but also of all other EU Member States.**

## C) The Excessive Deficit Procedure

- Firstly, **the Commission prepares a report** of the budget criterion fulfillment. **Following it, the EU Council makes a decision.** If a Member State exceeds a deficit ceiling, **a 6-month period is given to take measures (implement budget restrictions)**. During the following year, the budget deficit limit should not be exceeded.
- If within **6 months** the necessary measures have not been taken, the Council issues an **official warning** to the Member State concerned **(blue envelope).** If within the **next 6 months**, the measures which were recommended by the Commission have again not been taken, **sanctions** are imposed. First, the guilty party is obliged to make a **guaranty deposit in the Commission** including a **fixed component of 0.2% of GDP** and a **changeable component, equal to 1/10 of the difference between the identified deficit and the allowed deficit. <u>The size of the deposit , however, cannot exceed 0.5% of GDP.</u>**
- For example, if the Commission has seen a 4.0% deficit in Germany, i.e. exceeding the allowed deficit by 1.0%, then the guaranty given should be 0.2% +0.1% = 0.3% of Germany's GDP. The GDP of Germany is about Euro 2 500 billion, i.e. the guaranty should be about Euro 7.5 billion.
- If the deficit problem has not been resolved within a period of **2 years** (if deficit is not within the limits) the **guaranty is transferred into a fine** and goes into the **EU Budget** – no such case so far.

# 5. Fiscal Compact and EU Banking Union

Official name: **Treaty on Stability, Coordination and Governance in the Economic and Monetary Union.** Signed by **25 EU Member States** – all except **UK and Czech Republic.**

**The main rules of the Fiscal Compact are:**

✓ **National "debt brakes"/"golden rules":** The FC Member States commit to pass a **national law** or an **amendment of the national constitution** that limits the **structural budget deficit** to **0.5%** of GDP, from which a deviation is only allowed in "exceptional circumstances" or deep recessions. For countries with a debt-to-GDP ratio "significantly below 60% of GDP", the structural budget deficit may be as high as **1%** of GDP.

✓ **European Court of Justice:** A member state can now bring another member state before the European Court of Justice if it believes that the other state has **not fulfilled the provisions of passing a national "debt brake" into national law.** The **ECJ can impose a fine of up to 0.1% of GDP.**

✓ **The 1/20 rule:** This allows for an **excessive deficit procedure to be opened** if countries with a debt-to-GDP ratio of more than 60% do not bring that ratio down **sufficiently quickly**. The requirement is defined as an annual reduction of the debt ratio by **1/20 of the difference between the actual debt-to-GDP ratio and the 60% threshold.**

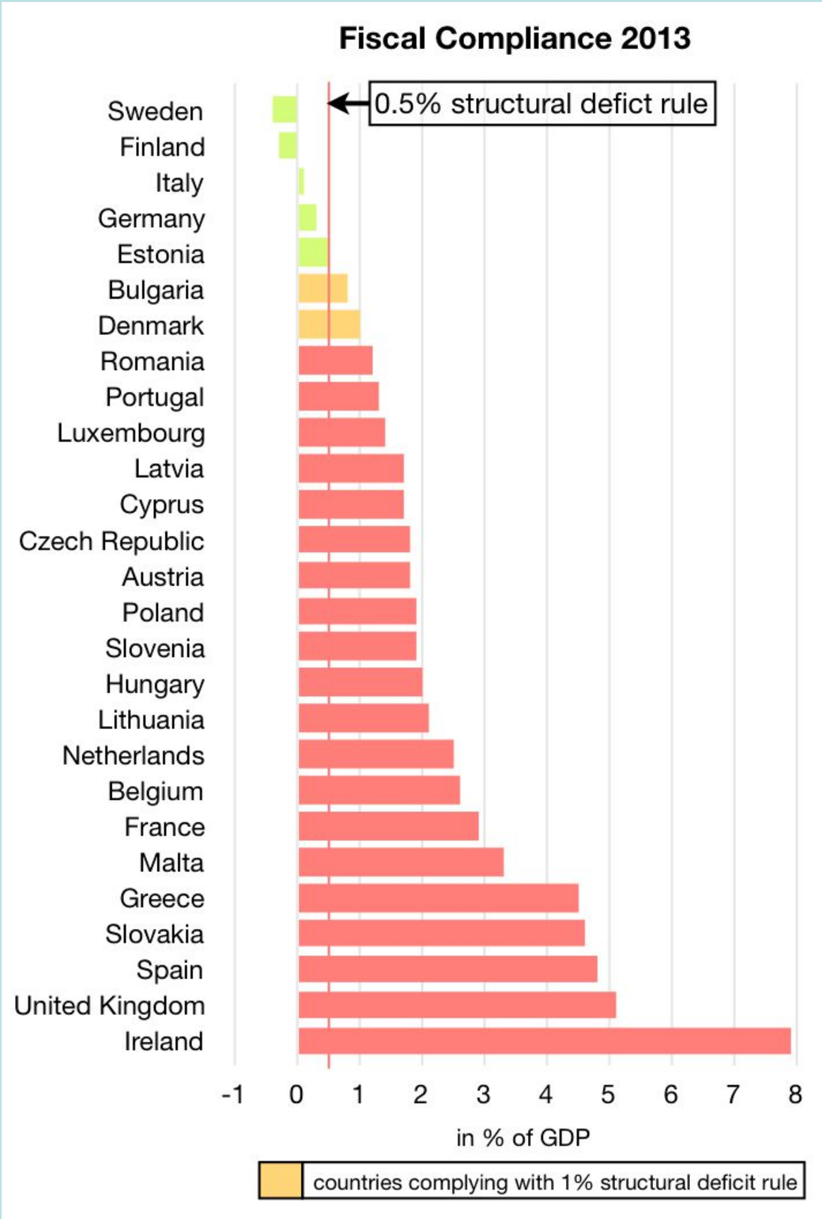
**Structural Budget Deficit**

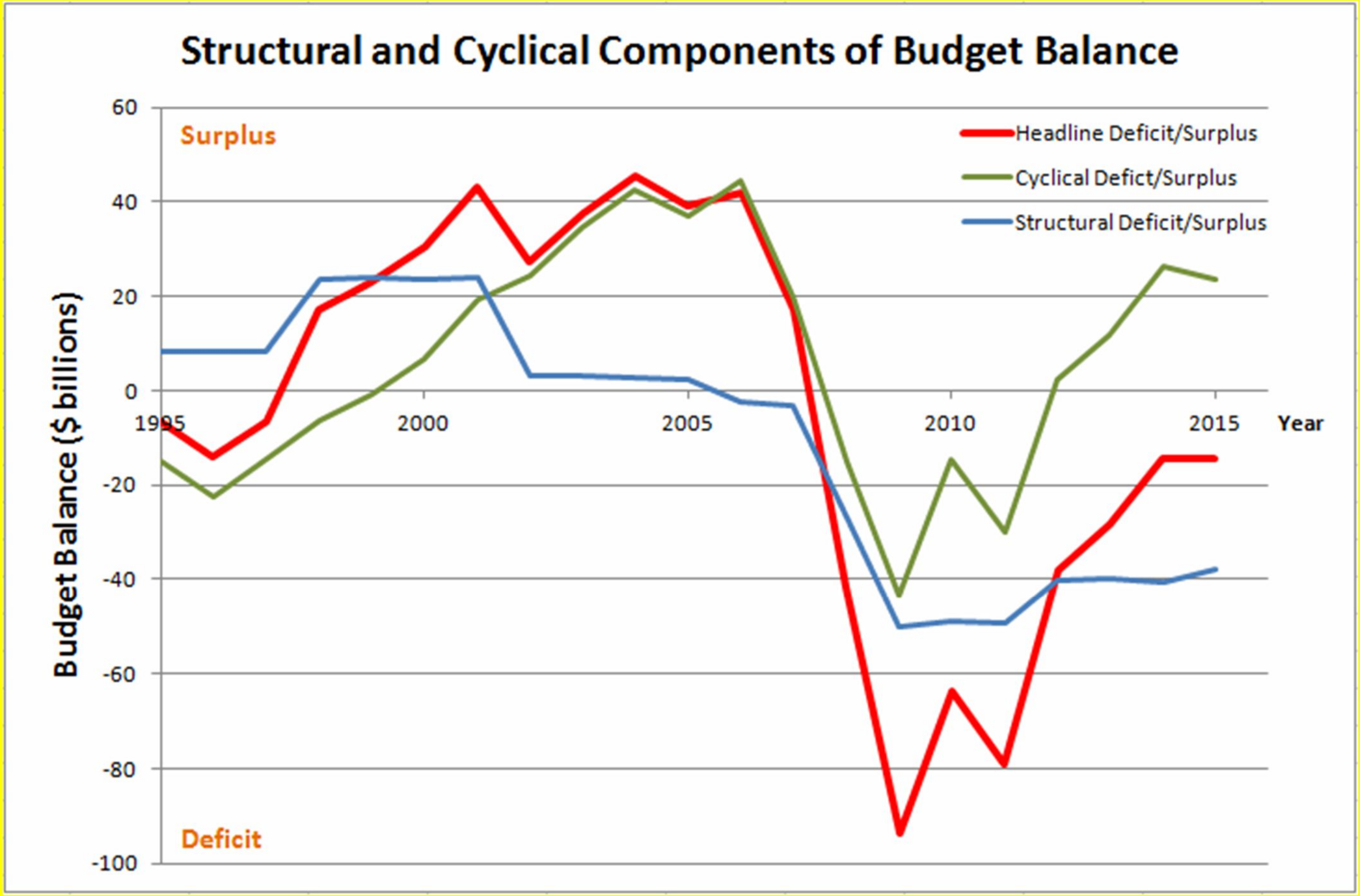
A structural deficit occurs when a country (or state, municipality, etc) posts a deficit even when the economy is operating at its full potential.

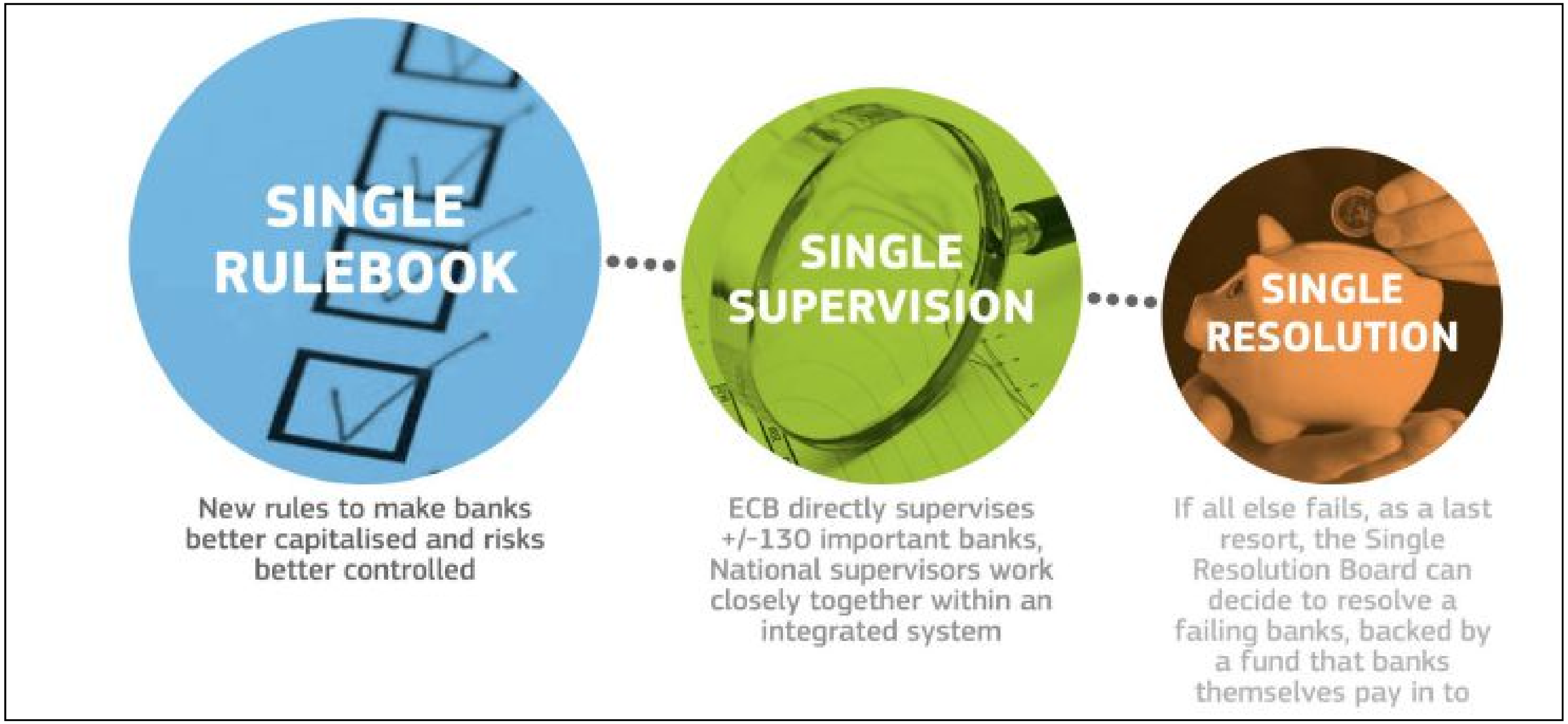
This is the opposite of a cyclical deficit in that a cyclical deficit only occurs when an economy is not performing to its full potential (for example, if an economy is currently struggling through a recession).

In time of recession the **headline deficit** includes **both components – the structural deficit and the cyclical deficit.**

For example in Germany in 2012 the general budget balance is – 0.9 % of GDP, the structural budget deficit is – 0.4% and the cyclical deficit – 0.5%.




Structural and Cyclical Components of Budget Balance
Budget Balance ($ billions)
60
40
20
0
-20
-40
-60
-80
-100
1995
2000
2005
2010
2015
Year
Surplus
Deficit
Headline Deficit/Surplus
Cyclical Defict/Surplus
Structural Deficit/Surplus




**1. The single rulebook is the foundation of the banking union. It consists of a set of legislative texts that all financial institutions (including approximately 8300 banks) in the EU must comply with.**

**These rules, among other things, lay down capital requirements for banks, ensure better protection for depositors, and regulate the prevention and management of bank failures.**

## 2. The Single Supervisory Mechanism (SSM)

**It places the European Central Bank (ECB) as the central prudential supervisor of financial institutions in the euro area (including approximately 6000 banks) and in those non-euro EU countries that choose to join the SSM.**

**As of November 2014, the European Central Bank will directly supervise the largest banks, while the national supervisors will continue to monitor the remaining banks. The main task of the ECB and the national supervisors, working closely together within an integrated system, will be to check that banks comply with the EU banking rules and to tackle problems early on.**

## 3. The Single Resolution Mechanism (SRM)

**It will apply to banks covered by the SSM. In the cases when banks fail despite stronger supervision, the mechanism will allow bank resolution to be managed effectively through a Single Resolution Board and a Single Resolution Fund, financed by the banking sector.**

**Its purpose is to ensure an orderly resolution of failing banks with minimal costs for taxpayers and to the real economy.**

**The EU Banking union Intergovernmental Agreement (IGA) was signed by 26 EU Member States (all but Sweden and the United Kingdom).**