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Is the European Monetary Union a Success Story?

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Abstract: After some quite successful firstyears of the European Monetary Union the Euro-crisis almost broke the union apart. It is therefore reasonable to question the idea of a monetary union and learn from the experiences. Did we benefit from the advantages of a monetary union that we know from economic theory? If not, is this a general problem or due to the special arrangements and history of the European Monetary Union? This paper tries to answer some of these questions with a focus on economic convergence and country participation in the light of economic and political discrepancies.
The EMU was successful in maintaining price stability in all years and positive growth rates in the early years. Oneother success criterion, financial and political stability, was not fulfilled. In the Euro crisis we had both recession and financial instability that induced political disturbances.
Keywords: *European Monetary Union, success criteria, convergence criteria, economic integration*
Source Photo Front Page: (ECB, 2008)

1. Introduction

During the past 14 years – that is after the founding in 1999 – the European Economic and Monetary Union (EMU) experienced ups and downs. Moderate GDP growth rates were followed by the Financial Crisis, now called the Euro Crisis, with steep Euro devaluation and public debt problems of several member countries and severe liquidity shortage of the banking sector.
After this turbulent period it is reasonable to question the idea of a monetary union and learn from the experiences. Did we benefit from the advantages of a monetary union that we know from economic theory? If not, is this a general problem or due to the special arrangements and history of the European Monetary Union? This paper tries to answer some of these questions with a focus on economic convergence and country participation in the light of economic and political discrepancies. Due to the limitations other answers cannot be given in detail.

2. Short historical overview and institutional setup of the EMU

The idea of a monetary union in Europe arose already in the late 1960ies. After ten years of experience with the European Monetary System, the European Council finally decided in 1989 to plan and implement a monetary union. The European Monetary System was a fixed exchange rate system with adjustable parities and can be seen as a predecessor of the monetary union.
In 1992 the Treaty on the European Union was signed. It included among several other topics a three-step plan for the realization of the EMU which should start by the end of the century.(Scheller, 2006, pp. 15-24)

A monetary union is defined by the irrevocable fixing of the exchange rates of participating currencies and the centralization of monetary policy, here assigned to the European Central Bank in Frankfurt that is located in Germany. Replacement of the national currencies by one single currency, like the Euro in EMU, is not absolutely necessary but is making sense to reduce transaction costs (Scheller, 2006, p. 25). The European Monetary Union started on 1 January 1999 with 11 countries(ECB, 2008, pp. 8, 9), with Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland.
It was clear from the beginning that economic convergence is necessary for membership in the EMU. With the loss of exchange rate adjustments in a monetary union it is crucial to have participating economies that do not differ very much regarding structure, productivity, productivity growth rates and GDP growth rates. Therefore convergence criteria were listed that had to be fulfilled by the countries before joining the EMU. They included

rules for public debt and budget deficits, inflation, long term interest rates and exchange rate stability(ECB, 2014a).

In May 1998 the EU Council/Heads of Governments “decided unanimously that 11 Member States had fulfilled the conditions necessary to adopt the single currency on 1 January 1999” (Scheller, 2006, p. 25). The point is: most of these 11 countries did not fulfill all of the convergence criteria. Inflation rate, long term interest rate and exchange rate stability can be influenced on a short term basis. These criteria were fulfilled as the countries had some years to adjust their policies until 1998. The one criterion that was not fulfilled was the overall public debt rate (public debt relative to GDP) that was supposed to be below 60%. Only three countries reached this number, two of the 11 countries even had ratios of more than 100% (Italy and Belgium)(*Convergence Report - Report required by Article 109 j of the Treaty establishing the European Community*, 1998, pp. 4-11). It was not a surprise that this threshold could not be reached by some of the countries within only a few years. It would have required very high yearly budget surpluses to reduce overall debt at this extent – which was unrealistic.

Nevertheless, the committee decided to include all these 11 countries in the EMU. Significant progress of deficit and debt ratio reduction was meant to replace proper fulfillment of the convergence criteria. That was probably the first “mistake” that later boosted the Euro crisis.

Before implementing the EMU officials agreed on the Stability and Growth Pact (SGP). The idea is to basically have the rules of the convergence criteria also in the monetary union. It should not be the case that a country loosens its financial policy after being accepted for the monetary union(Eichengreen, 2005, p. 430). Over the years several countries could not obey the rule for maximum budgets deficits (max. 3% budget deficit relative to GDP). But no country had to pay a fine to the European Commission, they only received an order to reduce the deficit. In fact the governments could reduce the deficits.

Since the founding of EMU seven more countries joined the EMU. Today we have 18 member countries in the EMU, out of 28 countries in the European Union(ECB, 2014b).

3. What is success in a monetary union?

Price stability is the explicit superior goal of the ECB(ECB, 2011Chapter 3) and therefore should be evaluated when discussing the success of the monetary union. The ECB stands in the tradition of monetaristic central bank policy – like many other central banks.

With the fixing of the exchange rate and the introduction of the Euro market participants no longer face exchange rate risks within the EMU. This is the main advantage that should foster growth of the countries' GDPswith higher trade volumes. Some other advantages are connected to this first one. Prices can be compared more easily, information costs are reduced, competition is increased. With only one currency transaction costs are minimized(ECB, 2008, p. 12).

Finally, the single currency for such a large currency area works as an international reserve currency, in addition to US-Dollar and Yen.

Of course, it takes some time to have all these advantages fully unfold(ECB, 2008).

From the advantages above we can expect **GDPgrowth** as one indicator of a successful monetary union.

One other set of advantages of a monetary union is described for example in Mongelli and Vega (Mongelli & Vega, 2006).

Normally and very importantantly, it is stressed that we need convergence for having an optimum currency area (OCA).An optimum currency area only includes countries with higher gains than losses from participating in the monetary union. Gains are described above. Losses are attributed to the fact that the country cannot conduct independent monetary policy for national economic stability. Monetary policy is centralized and conducted by one joint central bank. (Krugman, Obstfeld, & Melitz, 2012, pp. 596-608)

Briefly summarized, gains and losses depend on the level of economic integration between the participating countries. Integration generally is defined as a high level of factor mobility between the countries. Gains increase with increasing integration as the main advantage, lack of exchange rate risk with a predictable basis for decisions, is more important if we have a high trade volume, for example. (Krugman, et al., 2012)

Losses will be reduced with increasing integration. With high factor mobility in a currency area internal and external shocks will have a lower effect on the economies. The need for (now impossible) regional monetary policy is reduced, therefore.

The level of economic integration is an interesting matter for evaluating a currency area. We will evaluatethe optimum currency area criteria below when we look at some problems of EMU.

Besides the fact that we need an OCA before establishing the monetary union, integration and therefore the OCA-level can be increased *by the fact that we have* a monetary union.

The **level of integration** therefore is not only an important prerequisite (in the OCA discussion) but also can be an indicator of success in a monetary union itself(Mongelli & Vega, 2006, pp. 9, 10). The level of integration will be measured with intra-EMU trade volume as this is expected to rise.

Two views are generally shared. Either have convergence and integration before joining the monetary union, than no problems will occur. Or convergence and integration will be increased in the monetary union, as suggested as a consequence of positive effects on the integration(Mongelli & Vega, 2006, p. 9). But this is a risky way as it suggests countries to join the union that have not yet reached a sufficient level of integration.

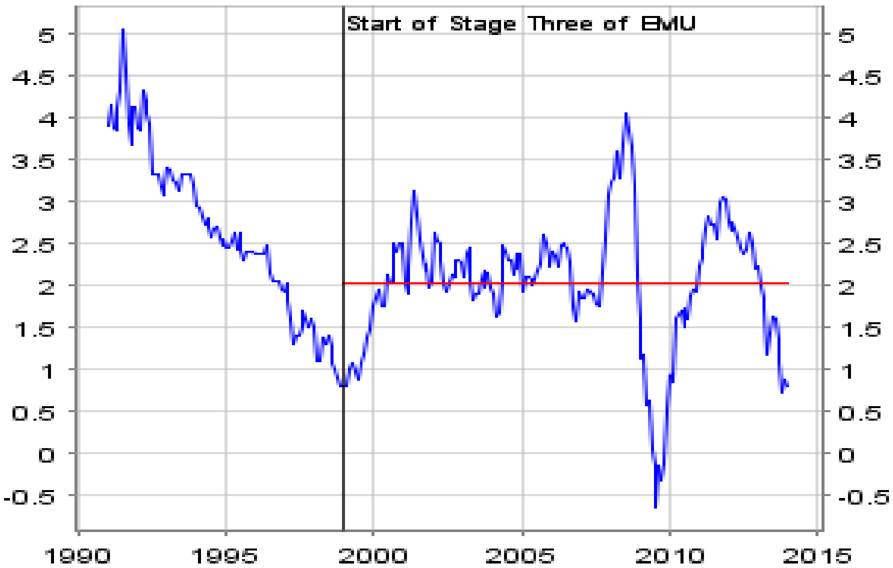
Besides these success indicators that are closely related to a monetary union, we have other indicators that we generally expect in any well established nation or area: successful economic policywith **political and financial stability**.

4. Experiences since 1999 - Analysis

1.1 Inflation

The aim of the ECB is to maintain inflation in the Euro area below but close to two percent. In the chart below we see that average inflation since the start of the monetary union is well in this range, with some disturbances during the Financial and Euro Crisis.

The goal of price stability therefore could be reached. (ECB, 2014c)



Source: (ECB, 2014c)

This is an interesting fact. Before the start of the European Monetary Union, many economists were afraid of high inflation in the Euro area. Especially in Germany, the biggest EU country with a strong tradition of price stability(Hasse & Starbatty, 1997). The experts expected high government spending (what we had) and bad influence of national governments on the ECB with consequently too expansive monetary policy. Obviously, we have severe problems in the monetary union and pessimists were right in several aspects, but inflation is not one of our problems.

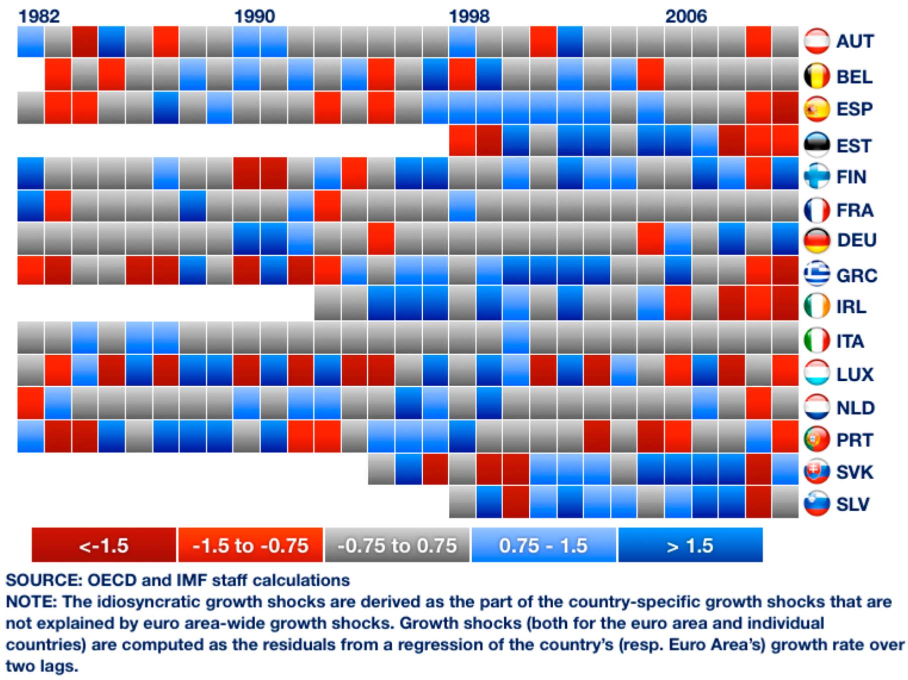
1.2 Growth

GDP growth is expected as one outcome after introducing one single currency in the Euro area, see above.

In this regard we have to draw a more diverse picture. GDP growth rates were quite different in the member countries of the EMU.

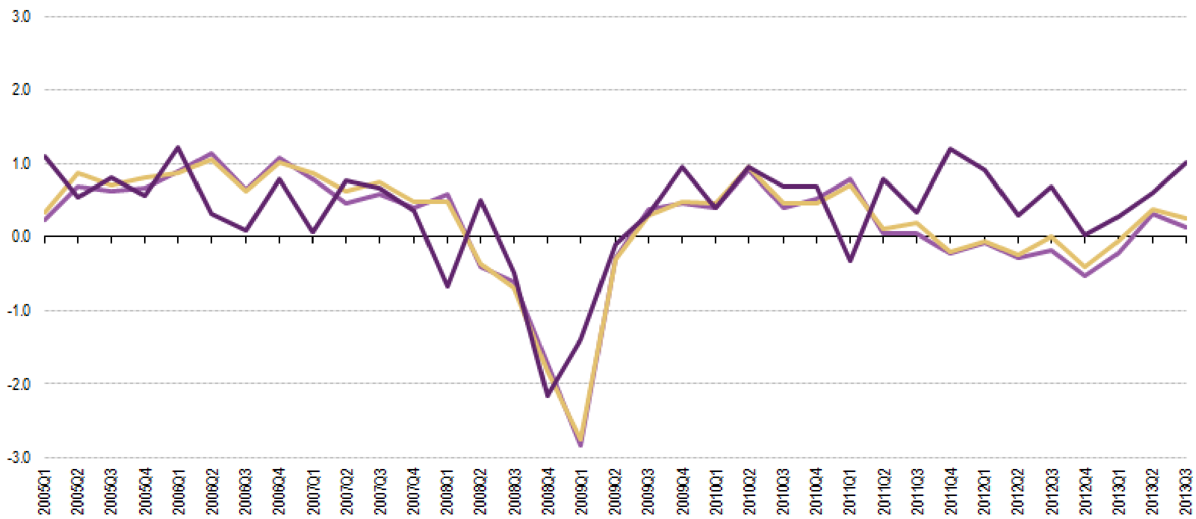
In 2008, after ten years of European Monetary Union, several studies explored the effects so far. Until 2007 GDP Euro area growth rates were quite stable around 2%. (ECB, 2008, p. 151)

But still during this period there were more national shocks than the founders of EMU had expected. Structural differences were still significant and were not reduced very much in the early years of the monetary union, as shown in the following figure where red squares indicate years with negative growth rates of below -0.75%. (IMF, 2013b, p. 9)



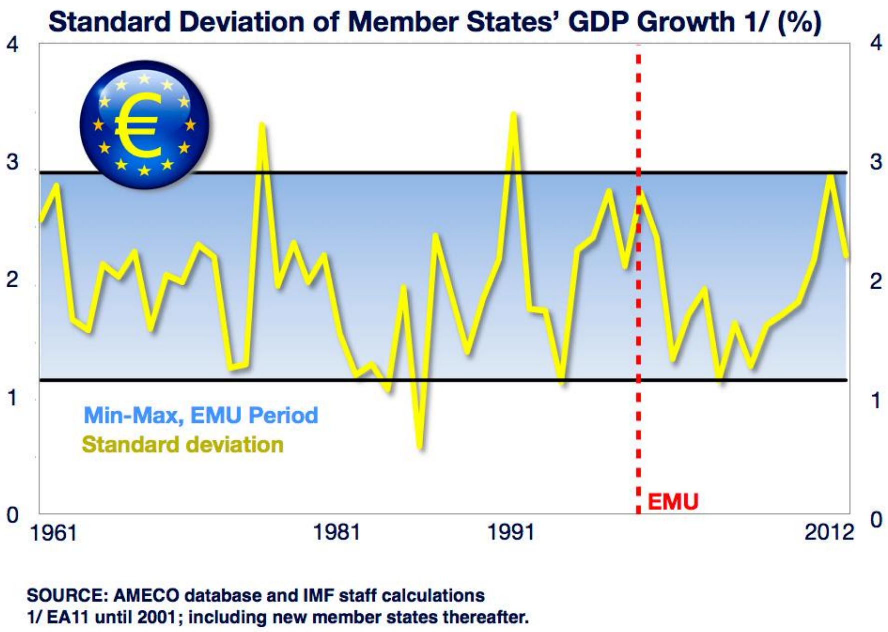
Source: (IMF, 2013b, p. 9)

From 2008 on the worldwide financial crisis has had its influence on the EMU. GDP growth rates were lower with periods of recession. See figure below.



Source: (eurostat, 2014), light brown line: EMU, light violet line: EU, violet line: USA

Of course, disturbances were not caused by the European Monetary Union itself. Nevertheless, this system of states with different economic structures was not able to cope with the problems very well. Divergences in the national growth rates remained significant as shown in the following figure. Standard deviation was reduced a bit but not as much as expected.



Source: (IMF, 2013b, p. 9)

It is worth to have a closer look at the structural differences. Markets in the EMU are not very flexible regarding price and wage adaptations. And labor mobility is not very high in the European Union(Janiak & Wasmer, 2008). This induces huge national differences in national business cycles during the crisis. If we have high capital mobility, sufficient mobility of goods and services at least for tradables and no exchange rate as buffer for country divergences, the labor market has to balance the differences. This is what we saw in Greece: Greece had a lower productivity growth rate compared to other EMU member states. Without EMU membership Greece could have devalued its currency over time and would have stayed competitive. In the EMU devaluation was impossible and Greek products were with higher labor unit costs too expensive. Consequently the people experienced high unemployment and much lower wages.

On the other hand, higher labor mobility would mean that people would move to areas with high employment rates and open jobs. Consequently, we would have even more crowded business areas and other areas with low population and even abandoned villages. This is what we observe in the east parts of Germany where after the reunion in 1990 many employees moved to (mostly western) industrial areas, leaving the elderly behind.

To sum up, recent years' recession was only partly initially caused by the EMU countries but in any case the divergent structure of the Euro area hindered a fast recovery.

1.3 Level of Market Integration and Trade

In previous years, there was a lively discussion on the effects of the European Monetary Union on the intra-EMU trade volume. It can be stated that there is some increase in international trade within this currency area. This was explored both in theory and with empirical analysis. But this effect differs a lot, depending on the research method. First high estimates proved to be wrong. For some of the papers the period of monetary union was too short and observed data therefore not sufficient. (Rose, 2000)(Baldwin, 2006)(Mongelli & Vega, 2006)

Empirical estimates of the positive effect on trade vary from 4 to 10 percent. (Mongelli & Vega, 2006, p. 18) or 5 to 10 percent and increasing for future years (Baldwin, 2006, p. 49). This is definitively one remarkable success of the European Monetary Union.
Unfortunately, the positive effects have an uneven distribution among the member countries.
Finland, Greece and the Netherlands even experienced disadvantages from EMU while all other countries (of the first 11 founding countries) had positive effects on the trade volume. The disadvantages could be due to a preceding policy of currency devaluation and hence export support that could not be continued in the monetary union. Detailed analysis also shows other steps in economic integration being responsible for higher trade volumes, like the Founding of the European Union, the Single European Act and else. (Camarero, Gomez, & Tamarit, 2012, pp. 16-20)

1.4 Economic and Political Stability
The worldwide economic crisis did not start in the European Monetary Union. But coping with the consequences showed the weaknesses of the system.
Soon after the beginning of the US banking crisis it was clear that many European banks were involved in this crisis. In 2008 and 2009 governments and other political institutions tried to deal with the almost breakdown of the interbank market and the consequences for credit volume and investments.
In 2010 the public debt problem of Greece became evident and was followed by a Euro depreciation. Others mostly southern European countries also had a debt and/or a financial liquidity problem.
Often mentioned weaknesses of the monetary union structure are the lack of financial supervision and the lack of political integration.
Improvement of financial supervision meanwhile was pushed with several agreements. A better supervision of the banking system is planned with the Single Supervisory Mechanism that centralizes financial supervision at the ECB. The plan is to establish a "banking union for the Euro area" (IMF, 2013a) that also includes direct recapitalization of banks by the ESM (European Stability Mechanism). The process is still under discussion, though.
Higher minimum equity quotes for banks are demanded as well, e.g. in the Basel III agreement. This brief summary of concerted actions by governments and ECB can only give an overview.
The lack of fiscal discipline and fiscal policy coordination is one threat that was mentioned from the beginning of the monetary union. But looking at the entry negotiations for the founding of the monetary union, we note that the convergence criteria were not fulfilled in all cases. As mentioned above, out of the five convergence criteria four were mostly fulfilled: inflation rate, long term interest rate, public deficit and exchange rate stability – these could be adapted to the rules within a few years. But the public deficit criterion was only fulfilled in France, Luxembourg and Finland. All other eight founding countries had higher debt ratios, ranging from only a few points over 60% up to around 120% in Belgium and Italy(*Convergence Report - Report required by Article 109 j of the Treaty establishing the European Community*, 1998). The decision what countries could join the union was a political one and not in line with convergence criteria! Not surprisingly some of the EMU countries developed a debt problem.
Coming back to the question of EMU success, the last five years clearly have not been very successful regarding fiscal matters and presented room for improvement. Especially the lack of economic policy coordination is an ongoing topic in discussions.

5. Conclusion
To sum up, besides success in maintaining price stability and positive growth rates in some years we found some of the success criteria not fulfilled. Nevertheless, a monetary union in Europe could be successful. In 1998 a monetary union would have been advisable with only a few countries like France, Germany, Denmark, Finland, Austria, the Netherlands and Luxembourg. These countries had more similar economic structures and proved convergence of the data. Austria and France even had voluntarily and unofficially fixed their currency to the German Mark over years. Introducing one single currency only with a few countries would have been possible. But from a political point of view it was all or nothing – a large number of European countries or no

monetary union, which would have meant the EMU-pushing presidents of some countries had had to resign. So it had to be the monetary union.

With all the regulation amendments of recent years some improvements of the EMU structures have been made. Still, we have a group of heterogeneous countries. Since the beginning of the crisis there is an ongoing discussion about some countriesbetter leaving the union – or even that we will have a breakdown of the European Monetary Union. What we have is a classical dilemma: either we have a split monetary union with a reduced credibility or we have this 18-country monetary union with all the structural and economic differences.

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