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# SIGNIFICANCE OF THE EMS AND THE EVALUATION OF EURO IN THE EUROPEAN INTEGRATION PROCESS

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## ÖZET

*Genelde büyüyen gelişen Avrupa Birliği (AB) ve özellikle Ekonomik ve Parasal Birlik (EPB), ki ekonomik olarak kutuplaşan dünyaya Avrupa'nın önemli meydan okuyuşları olarak görülüyorlar, günlük hayatımızda kayda değer bir yer teşkil ediyor. Bu makale, Avrupa Para Sistemi (APS), EPB, ve Avrupa Döviz Birimi'nin (ADB) rolünü tarihsel bir olay olarak Avrupa bütünleşme süreci içerisinde açıklar ve ayrıca EPB sonrası durumu – ekonomik ve politik – sonuçlarını 'entegrasyoncu' perspektifinden değerlendirir.*

## ABSTRACT

*The progressive development of the European Union (EU) in general and the Economic and Monetary Union (EMU) in particular, which are seen as major European challenges in an economically polarising world, occupy a significant place in our every day life. This article explains the role of the European Monetary System (EMS), the EMU, and the European Currency Unit (ECU) as a historic event in the European integration process and also assesses the consequences of post-EMU circumstances – economically and politically – from the integrationist perspective.*

## Outlook

It would be necessary to clarify first what does 'integration' precisely means within the context of this article. The dominant view in academic circles is that economic and monetary integrations in the EU are the product of an *intergovernmentalist* theory: a close co-operation through the convergence of member states' monetary and fiscal policies to each other for achieving their national foreign policy goals. According to this theory, although economic and political issues of foreign relations have moved closer to each other, distinction between them has remained. Even if the situation seems so, concepts like intergovernmentalism and national sovereignty have in fact *de facto* been weakened by the intensification of interdependence between the EU member states.

The progressive development of EMU and other relevant monetary institutions, which are built on the EMS, should be conceived from the view of *functionalist* theory. This theory concisely refers to the integration of liberal economic ideas through spillover: participant countries to the EMU are gradually giving up their sovereignty in monetary as well as in political domains to the EU's supranational institutions as integration deepens. That is, European integration is a continuous process of transferring divergent national economic and monetary policies from the old nation-state, national sovereignty model to a collective endeavour. In view of this, the Euro, the currency unit of the EMU, has a unique quality of not being issued by a sovereign government.

As manifestation of this, the European Commission's 'One Market, One Money' slogan, which is used for completing the European single market project (free movement of persons, services, capitals and goods), is no more than the assurance of functionalist theory. All signs of the European integration process, which is based on liberal economic practices, are pointing to that united Europe is gradually emerging due to the process of globalisation and will remain an influential power in global economy throughout the 21<sup>st</sup> Century.

Concurrently, this article will not only analyse the economic and monetary aspects of integration with regard to the EMS and the EMU, but will also put emphasis on political implications of this type of integration from the functionalist theory point of view. The 12 participant members of the EMU are: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal and Spain. The other three EU members – UK, Denmark and Sweden – enjoy an opt-out status.

## Historical Background

For a better understanding of the significance of the EMS, the EMU, and the ECU, this part of this paper looks briefly back into history to investigate the foundations of their development. The process of founding the EMS, which came into being after a series of tough debates, can be understood better by reviewing international monetary and political events that affected the world and, particularly, Europe in the early 1970s. For the first time in history, the principle of 'territorial' currency, which is based on national sovereignty and entrenched in the Peace of Westphalia (1648), is seriously and increasingly challenged by European monetary transformations, the EMU initiative, and currency substitution towards the end of 20<sup>th</sup> Century.

As early as 1969, Pierre Werner had planned to go beyond the European Monetary Agreement (1960) for the aim of achieving a monetary union by 1980. This was the first attempt to integrate European currencies in a monetary system, known as 'the snake in a tunnel', where the dollar would have been taken as reference currency (Taylor 1995:12). As a result of unrealistic narrow fiscal margins of the snake system, breakdown of the Bretton Woods System and the Yom Kippur War between Egypt and Israel, which led to the oil crisis worldwide, resulted in a major international monetary turbulence. Under these conditions, it was almost impossible to give life to that planned monetary

union within the European Economic Community (EEC) at that time.

Meanwhile, after a surprise revitalisation of the Werner Plan in 1978, the EMS was created in 1979. It incorporated two main institutions: the Exchange Rate Mechanism (ERM) and the European Currency Unit (ECU). However, this Plan disappointed those who wanted to agree on a timetable for the ultimate realisation of the European monetary union. The declared objective was relatively modest: creating a zone of monetary stability through controlling inflation, unemployment and balance of payment deficits; promoting a high degree of convergence of economic performance, economic and social cohesion and solidarity among the EU member states. In order to achieve this objective, 'Cohesion Funds' and 'Structural Funds' are found in 1993 for fulfilling economic and financial convergence criteria through the compensation of the poor by the rich EU states (Duff, Pinder, Pryce 1995: 20).

Thus, the ERM replaced the failed snake system and installed a new inflation fluctuation margin (+/- 2.25%) in relation to the ECU, as the dollar had once been considered in the snake system. The ECU, a basket of 12 European currencies, was used as a reference value for the European authorities and financial markets in addition to its role as a unit of account in the EMS. Even in the private sector, companies used it for borrowing or loaning currency reserves in order to protect themselves from possible exchange rate fluctuations and risky foreign currency transactions (Goodman 1996: 223).

The creation of EMS proved that member states of the European Community (EC) became not only relatively interdependent to each other through a collective commitment to realise the ECU, but also inevitability of strengthening political co-operation at the Community level became necessary for the proper functioning of the common monetary system. Even if the ECU was limited to areas related to accounting and not really used in practice, it constituted the basis of the Euro – the currency unit of the EMU. During the Dublin European Council meeting in December 1996, it was decided with reference to the Article 109L of the Maastricht Treaty that the Euro would come into effect together with national currencies, which are in the ECU-basket, from January 1, 1999, onwards. What was the main idea behind the EMU and how conditions to it were prepared during the Maastricht Summit? The next section will provide the necessary background for the in-depth analysis

of these questions from economic and political perspectives.

## **Economic and Political Pillars of the Maastricht Treaty**

Towards the end of 1980s, the EMS had been convincing and enticing so that some political and economic analysts began to consider deeper European integration in the monetary and political domain. One of the prominent personalities in the EC and the architect of the European single market plan, Jacques Delors (former President of the European Commission), proposed a three-stage plan in 1989 for the realisation of the EMU. Each stage of his plan was proposing a wider and deeper integration. *Stage one* brought and tied different European currencies into the ERM; *stage two* created the European System of Central Banks (ESCB) and prepared an appropriate ground for the finalisation of monetary integration – exchange rates were fixed and most of market operations were held in the Euro; and, *stage three* introduced the single European currency (Euro) and became the last stage in the completion of the European Central Bank's (ECB) formation, an institution where important decisions will be taken on monetary policy matters.

Even though the ERM had to pass through various crisis situations and important deadlines on the way of achieving the EMU sometimes had to be postponed, the organisation of this three-stage plan was kept robust until the finalisation of stage three with the introduction of Euro by January 1, 2002.

The European integration process is principally reinforced by the EC's Maastricht Summit in December 1991, which led to launching two conferences as to first Intergovernmental Conference (IGC) on the EMU and second IGC on the European Political Union (EPU). The completed Maastricht Treaty was not only about monetary integration, but also about political integration. As an evidence to that, two new pillars, Common Foreign Policy and Security Policy (CFSP) and Common Action in Justice and Home Affairs (JHA), have been established beside the first EEC pillar and the Schengen Convention and the Social Chapter have been implemented by a group of EC member states. The aim with the desire of creating the EPU was to give the EC greater political power in the area of foreign and security policy in order to match its growing economic might.

The entire Maastricht Treaty instituting the EU was ratified by all member states, except for the United Kingdom, Denmark and Sweden opt-out clauses have been granted in the area of EMU, Schengen Convention and Social Chapter; the UK and Sweden opted-out in all areas, whereas Denmark opted-out the EMU only. Thereby, these countries are not committed to the procedures and rules in these areas.

In order to comprehend the difficulties with regard to the EMU, one has to look at the general economic situation in the EU. What will happen if one member state faces with an asymmetric financial impact that will consequently be forced to react differently than other member states to the same impact? At the time of a domestic economic recession, it is difficult to regulate the budgetary policy of, particularly, big countries at the EU level which was and is still today one of the biggest problems for most of states. Many governments try to reduce their national fiscal deficits by raising taxes, cutting social funds and privatising national firms.

However, in order to recover economic recession at home, most of the time states find themselves in a position of changing their traditional policies in favour of co-operation with other EU states. These fiscal pressures, which led to the commitment of building a unified economic and political community, explain why the EU policymakers devoted to create new monetary structures with the end of the East-West tension after the 1990s.

## **The Economic Pillar: Introduction of the Euro**

Introduction of the Euro, which is the product of painstaking preparation, brought the European integration process into a new stage: The 'point of no return' is reached with the EMU's coming into effect on January 1, 1999, among the 12 EU members and the Euro had began replacing national currencies as of January 1, 2002, and became the sole currency in the Euro-zone together with the ECB on June 30, 2002. The ESCB's Governing Council, which is including the ECB's Executive Board situated in Frankfurt am Main and the presidents of national central banks, is the supreme authority in devising a supranational European monetary policy. The Euro became the main private currency for investment purposes, which internationally performs all three functions of money as a medium of exchange, a unit of account, and a standard of value.

The primary objective of the ESCB is to maintain price stability with the ECB. The ECB must remain fully neutral (Maastricht Treaty 1993: Article 105) and of course carries the sole right of printing and issuing banknotes. Neither national governments nor the EU itself have any right giving instructions to the ESCB and other EMU institutions. The heads of government appoints the six members of the ECB Council, which comprise of the president and vice-president of the ECB, and the four other members (Maastricht Treaty 1993: Article 109a). The presidents of national central banks are responsible for the execution of Council decisions. The ECB Council members have equal voting rights and decisions are taken among themselves by a simple majority vote. If the voting process reaches to a point of impasse, then the president's vote is becoming decisive for the side he voted for. The Dutchman, Wim Duisenberg, is appointed as the first president of the ECB together with the other members of the Executive Board on May 1998. He will be replaced by Jean-Claude Trichet, head of the French central bank, as the next president of the ECB on May 2006.

The former German Federal Bank (*Bundesbank* or, shortly, *Buba*) president, Karl Otto Pöhl, established the ECB mainly on principles and structures of the Bundesbank. Therefore, similar to the federal structure of the German monetary system, which is founded on a centralised federal banking and a number of *Landeszentralbanken* (state central banks) model, the ECB is responsible for determining interest rates and regulating the money supply (Europa 2002: 21-23).

Due to the EMU members prefer mutual trade among themselves within the Euro-zone, this integrated economic community is somewhat a closed economy. Nevertheless, policymakers in the EU are less concerned about fluctuations in the foreign exchange value of the Euro, since the 'Stability and Growth Pact' – initiated by Germany in 1996 – compels the Euro-countries to attain monetary stability through guaranteeing common binding fiscal criteria. According to the Maastricht Treaty, it is the EU Council of Ministers that has the authority over the 'general orientations' of exchange rate policy. By leaving the decision of regulating the exchange rate on a day-to-day basis to the ECB, the Council of Ministers 'have agreed only to issue so-called orientations for exchange rate policy in exceptional circumstances such as a clear misalignment of the Euro which is likely to persist' (Solomon 1999: 9). The interest rate of the ECB, which was approved corresponding to the basic rates in France and Germany, is 3% for all the entire Euro-zone.

Under the light of these developments, competition in the EU single market zone has increased considerably with the introduction of the single currency. The increased competition and the elimination of transaction costs, which are likely to pull prices downward in the long-term, are providing a favourable ground for the merger of two or more similar industrial units. The Euro-zone is the world's largest trading partner and seemingly will increase its current share of global exports above 20% in the near future.

Even though the EMU members have given up their national exchange rates and balance of payments policies to a supranational institution, they retain some of their sovereignty in domestic fiscal policy area. One thing that needs to be seriously understood is that the commitment of building an integrated economic and political community is reaching to the very centre of monetary reforms through transformationalist effects. These transformations are the manifestation of the functionalist theory.

### **The Political Pillar: It cannot lag behind the Euro**

One of the most intricate questions is how the EMU, which is consisting of 12 sovereign countries with their own political structures, will function politically in Europe and in the world? Will the introduction of the Euro also promote to the political integration of Europe?

The immediate answer to these questions are historical and goes back to the major Franco-German objective of achieving political integration of the EU along with the economic and monetary integration. The economic and monetary integration of Europe has been alluring and became a major motivation for the former French President Charles de Gaulle and his German counterpart Chancellor Konrad Adenauer on the way of achieving the EPU since the 1960s. Although the EC's political integration was not politically feasible at that time, it was only made possible through integrating in various ways in the economic sphere. Therefore, the foundation of the EMU with the Maastricht Treaty in 1993 was not because of the EU's economic and monetary reforms were attributed to war-driven factors in the aftermath of the East-West tension, but to security-driven factors including political, economic and social threats, which they have emerged in the new security environment since the 1990s.

In practice, the European integration process is increasingly affected by two main factors: The EMU and the ongoing European enlargement negotiations. The Euro has important political implications to arguments that link contemporary monetary transformations to a challenge of the nation-state structure. That is to say, the Euro is not just an economic and monetary phenomenon of the 12 combined national currencies, but it entails a certain commitment to co-ordinate and integrate national policies geographically, politically, and psychologically. Many would agree that the Euro is politically strengthening three important features of the EU on the way of constructing a common European politico-economic identity: the territorial coherence of the EU's economic and monetary integrity, the EU institutions' more direct link to and administration of the 'citizens' of the EU, the sense of European collective identity that makes national citizens more receptive to the EU norms and values.

The point here is that the Euro is politically becoming for the EMU member states not only a common ground for their growing together, but also a common destiny –economically and politically – for the overall Community. It brings the nations of EU closer together and reinforces existing interrelationships and mutual dependence. The constitutive importance of Euro is that it establishes a 'community of nation', a collective economic and political unit, that is running as a key integrating power for the entire Euro-zone.

One of the most significant outcomes of this section is that further European political integration is necessary for making the entire EU system healthier and workable. During the last few years, the Euro has already given great impetus to the political integration of Europe and is another major building block in achieving a common European political identity. Hence, the European economic and monetary integration should be seen as a significant step towards political union for the better functioning of European foreign policy and security strategy – Common Foreign and Security Policy (CFSP) (Issing 1996: 3).

A decade ago only a few optimists was predicting that the Euro-zone would acquire such a remarkable and a credible economic and political clout on the world stage. Currently, there are many evidences indicating that the EU would become an influential political power in addition to its significant regional and global economic role. The economic and monetary developments in the EU are radical levellers that do away with distinctions pertaining

to the traditional political interactions between sovereign nations. On the whole, these developments should be seen from a broader historical perspective, because national monetary and political initiatives could not generate a successful *communal* administrative system in the absence of one of these initiatives at any time in the past.

## **Monetary and Macroeconomic Implications of the Euro**

It will be helpful to analyse monetary and macroeconomic implications of the EMS and its ERM for the EU and to the rest of the world. Putting together national currencies in an exchange rate system, known as the ERM, means in some way urging participant states to work together at least at a monetary policy level. McCormick stated that, by working together, the states are somehow committed to 'sinking and swimming together' (McCormick 1996: 37). Thus, any change in the economic condition of one of the big states has significant implications for the economies of other states. This can be demonstrated by a simple fact that decisions of the Bundesbank to raise or lower its interest rate, forces most of other European Central Banks to accommodate their fiscal rates to those new economic conditions.

There is no doubt that a range of implications of this kind of fiscal interactions are becoming an incentive to macroeconomic regulations among the EMU states: liberalisation of capital markets and integration of national financial markets through the harmonisation of monetary and fiscal policies, elimination of exchange rate disparities along with the harmonisation of taxes, elimination of transaction costs and equalisation of interest rates (Goodman 1996: 208). Nevertheless, as it is predicted in the *Economist*, these regulations toward a 'single, harmonious capital market' are 'grudgingly slow' (The Economist 1998: 72).

One of the most important tasks of the EMS is to keep inflation under control by using the ERM. Due to all member states that have to comply with the central rates of the EMS, they cannot easily apply competitive devaluations within their economic systems for the aim of boosting their economic growth. The ERM became an attractive system in balancing devaluations and controlling anti-inflationary economic processes throughout the EU. Moreover, restrictive fluctuation margins of the ERM, not only forces governments to keep their commitment of working closer with each other at

the monetary level, but also forces them to co-ordinate their economic policies at the political level.

Although the ERM reached to a point of collapse after far-reaching speculations on the world money market during 1992-1993, the whole EMS surprisingly appeared to be strong enough and remained a reliable starting point on the way of realising the EMU (Dyson 1994: 326). Therefore, the ERM has so far been quite successful in regulating inflation rates between the EU member states. The strength of the EMS can be explained by the fact that its ERM has been a successful method in lowering inflation rates to almost an ideal 2-3% level in those EU countries that are committed to the Euro (Europa 2002: 22). This level is one of the essential Maastricht criteria of the EMU and the ECU; both of which are the foundations of the new single currency, the Euro.

The EMS has been successful in fighting against inflation in Europe and improved co-operation among national central banks, but it was not the right institution that would facilitate the transition into a common monetary union. What was needed a structure that would encourage more co-operations among central banks and impart greater credibility to the commitment of attaining a fixed exchange rate. Therefore, the European Monetary Institute (EMI) institutionalised the EMS and took over its functions in 1994. The EMI successfully co-ordinated monetary policies among the EC member states, provided a significant momentum for the integrationist movement in Europe, and prepared a stable ground to the EMU. Therefore, the Euro has gained a worldwide reserve currency quality and gradually began competing with the US dollar through functioning as an international asset and means of payment for the private sector.

These functionalist developments provided the EU much more internal coherence and power than it had had in the pre-EMU period and facilitated drawing a clear economic and monetary boundary between the Euro-zone and the rest of the world. With the Euro in existence, 12 countries increased their trade with one another and consumers began purchasing more products that are made in the Euro-zone. Therefore, it is easy to expect that companies working with the same currency are likely to do more business with each other than those that have different currencies; imports from and exports to non-EMU countries would increase less rapidly than in the past (Solomon 1999: 3). Despite of this, the EMU countries' trade with other

countries, which are using the Euro as reserve currency, is increasing outstandingly.

## **Opt-Out Status for NonParticipants**

What would happen to those EU states, which are still rejecting to join in or failing to meet the convergence criteria of the EMU? The EMU is probably the first development in the history of European integration where some countries will not be allowed to move ahead together with other integrationist states in the EU; they have to first qualify the EMU criteria.

During the Amsterdam European Council meeting on 16-17 June 1997, the question of non-participants (the UK, Denmark, and Sweden) to the EMU was raised and, after a thorny debate, a new principle adopted by the European Council: The new exchange rate mechanism (ERM-2) became operational on January 1, 1999. The ERM-2 is formulated for the aim of co-ordinating financial interactions between the non-participants and participants to the EMU. The Euro will be the reference currency of non-participants similar to the ECU was for the ERM. This regulation is in fact aiming to treat non-participant states on the same level as participants by aiding them to regulate their monetary policies with the EMU convergence criteria through stabilising exchange rate differences, reducing financial fluctuations and acting as their shield against external monetary pressures that might come outside of the EU.

Even if two groups of states have inevitably emerged at different integration levels, one of the principal targets of the EMU participant states is to minimise the divergences that may occur between this two groups of states.

## **Conclusion**

The main aim with the creation of the EMU is to bring about a positive impact on employment, enhance balanced development of the regions in the Euro-zone, and provide the EU prestige with a greater economic and political bargaining power in the world. Ostensibly, these developments might probably be a significant incentive in the realisation of the metaphor called the 'United States of Europe' in the future. In this paper, I have attempted to analyse the importance of the EMS,

the EMU, and the ECU and drawn particular attention to political aspects of the economic and monetary integration in the overall European integration process from the functionalist theory point of view.

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