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From Common Market to Emu: A Historical Perspective of European Economic and Monetary Integration

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Introduction

The concept of a United States of Europe has a long history. Down through the centuries, attempts have been made to unite the mosaic of European nations either through military might or though intellectual persuasion. Intellectuals continued to propagate the idea of European collaboration, though without much political support. The notion of a European Parliament was first espoused by William Penn in 1693. In 1795, Immanuel Kant stressed the need for a league of nations and a Federal Europe. Later Victor Hugo argued for a European Federation after the Serbians rose against the Turkish domination in 1876. Its more immediate ancestry can be traced back to the First World War when Friedich Neumann advocated the creation of a common market and stressed the importance of the development of economic relationships between countries as a driving force for economic and then political integration. After the First World War two French politicians, Aristide Briand and Edouard Herriot took up the ideas of Richard Coudenhove-Kalergi, propounded the idea of a Federal Europe which was security minded and gravitated around the Franco-German relationship. These ideas on European union were swamped by the tidal wave of nationalism and the idea of the nation-state which reigned supreme in the period 1914-1945. But after two wars, these ideas became relevant and fashionable again (Wilson and van der Dussen, 1995). The roots of an European single currency and monetary union can be traced back to the start of the common market in 1958 and possibly further still to the creation of the Latin Monetary Union by Belgium, Italy, Switzerland, Bulgaria, and Greece 130 years ago.[1]

Since the establishment of the European Economic Community (EEC) in 1957, attempt at monetary integration and, ultimately monetary union, have tended to assume importance only as a result of financial crisis and becoming a vague objective as soon as the crisis recedes. In recent years, however, this search has assumed greater urgency for three main reasons. First, monetary union can be viewed as a response by European policy makers to the increases of intra-European trade which has meant that different currencies and fluctuating exchange rates have become an increasing nuisance. Since the successful implementation of the Single Market Programme this has become more evident. Second, politically, there was a continual search for increased stability and security in Europe, which crucially hinged on anchoring Germany within Europe. And third, many economic interest groups perceived a single unified and integrated European economy as serving their interests (Pinder, 1996, p. 123).

Economic union, on the other hand, has followed a smoother transition path. Economic integration was used after the Second World War to realize political goals, chiefly to anchor West Germany within a Western European alliance. Under this scheme common governance was deemed to be the best structure; other structures such as intergovernmental cooperation were not perceived to be as effective. The European Coal and Steel Community (ECSC), in 1951, was the first attempt at creating such a governance structure, which was described by Jean Monnet, the ECSC's architect, as the 'first concrete foundation of a federation which is indispensable to the preservation of peace' (Pinder, 1996, p. 124). The ECSC treaty which set up a custom union for coal and steel materials was followed by the European Economic Community (EEC 1958), the Single

European Act (SEA 1987) and the Treaty on European Union (TEU 1993), each new treaty either extending the scope of the community or refocusing its objectives. Writing at the beginning of 1999, many of the European Union countries have locked their currencies together and adopted the euro for electronic transactions, with the intention of full monetary union by the middle of 2002 Only then will we be able to judge its relative success when compared with other attempts at economic and monetary union.

The Origin of European Cooperation

After the Second World War most European economies lay in ruin or were severely disrupted. The deleterious results of the war were manifest in the infrastructure and the poverty affecting large sections of the population which created the potential for social upheaval. The poor harvest of 1946 and the drought of the summer of 1947 placed further strain on European economies. Apart from the devastation and the loss of millions of lives, the Second World War created some profound discontent with international arrangements which had promoted conflict between nations and had enabled the growth of Fascism. The prolonged inter-war depression with its accompanying poverty and mass unemployment generated the desire for economic change. The period before the war was characterized by international disintegration (Tsoukalis, 1997, p.10). Countries emphasised national economic autarky and state control of trade and industry intensified. The events of the pre-war pre-war period (e.g. the depression, disintegration of the international economy, the rise of Fascism) and the experience of the war helped to create a political atmosphere tolerant of notions of co-operation and federalism at the European level. And as war-ravaged countries sought to reconstruct their economies, the Marshall Plan helped sow the seeds of European economic cooperation.

All European countries were hungry for reconstruction funds and America was the only country capable of providing much needed financial resources. For its part America was quick to realize that their assistance was urgently needed in order to assist economic recovery, and to forestall further social unrest and the build up in support for the left-of-centre in politics (Jovanovic, 1997, pp. 2-3). But American aid in the form of the European Recovery Programme (Marshall Plan) was conditional on cooperation among European governments and progressive liberalization of intra-European trade and payments (Tsoukalis, 1997, p. 9). The aid was offered not on a bilateral basis but on a continental basis. In order to comply with the conditions of the Marshall Plan, and to co-ordinate and realize its objectives, the European governments established the Committee of European Economic Cooperation (CEEC). The motive behind American aid was not entirely altruistic, it also helped to serve America's strategic interest. By assisting the integration of the European economies back into the world trading and productive systems America hoped to create stable and reliable partners. The Marshall Plan was approved in 1948 and America poured $15 billion of aid into the debilitated European economies. Having created the CEEC as an ad hoc institution to meet the demands imposed by American aid, the need for a more permanent institution soon became apparent, consequently, in April 1948 the Organisation for European Economic Cooperation (OEEC) was created to provide a long-term forum for economic cooperation. Discussions prior to the creation of the OEEC were heated and centred on two opposing views on economic cooperation: the British-Scandinavian view and the French-Continental view. These different interpretations on how economic cooperation should develop would be echoed many times in the future and would eventually lead to the creation of the ECSC.

Mostly in Western Europe, a range of bodies outside of governments and the established political parties were launched to campaign for European unity and for pan-European political structure. It was hoped to replace the old political system with a new political system which would be organized in such a way as to prevent war recurring. Foremost among these groups were Alto Spinelli's Union of European Federalists which sought the creation of a united Europe along federal lines and the less ambitious United European Movement, set up by Winston Churchill in 1947, which advocated a limited form of European integration within an intergovernmental framework. These two distinct groupings reflected the division between the French-Continental approach and the British-Scandinavian approach, which was based on political, cultural and geographical differences. At the Hague in May 1948, representatives from the European movement gathered to hold a Congress of Europe, at which matters of common interest would be debated and methods for promoting greater political and economic co-operation would be devised. Differences between the federalist and functionalist positions came to the fore at the congress. Although both groups agreed on the same broad aims: the desirability of European Union and the need to create an international organisation with a parliamentary body, they differed on the method of implementation. One proposal to the Congress, which came from the

‘federalist’ camp and received support from the French and Belgian governments, called for the creation of a European Assembly with legislative powers and a Committee of Ministers who would prepare and implement the Assembly’s decisions. A counter proposal made by the British government and functionalist in nature advocated an assembly of government appointed delegates who would be responsible to an inter-governmental body. After six months of deliberation, a compromise was reached which established a Council of Europe, consisting of a Committee of Ministers, responsible to national governments, and a Consultative assembly to deliberate and make recommendations to the Committee of Ministers, but to have no legislative function.

Although floated as a compromise, the adopted proposal was a defeat for the federalists. The Council of Europe served only as a forum for the exchange of ideas and information, its only important legacy was in the area of human rights.[2] Shortly after the fledgling political assembly came into being, its shortcomings were evident to the more federal-minded members. Among these members of the Assembly there was growing dissatisfaction with the existing powers of the European Council. In order to rectify this, a series of proposals were made to extend and deepen the power of the Assembly and of the Committee of Ministers to allow them to pass European acts binding on all participating states without the ratification of national parliaments. These proposals were unacceptable to Britain and the Scandinavian countries. Despite efforts to reconcile the federalist and functionalist approaches to European union, an impasse was reached. The failure to extend the Council’s powers and the slow progress towards European union frustrated the ‘federalist’ members who realized that quicker economic integration would have to be achieved outside the institutional framework provided within the Congress of Europe. These members sought the creation of an alternative institutional structure to speed up economic integration. Their answer was to develop economic co-operation outside the framework of the Council of Europe.

One person who had remained detached from the wrangling of the Congress of Europe was Jean Monnet. As early as 1943 Monnet, who was director of the French Modernisation plan, suggested that the only way to prevent war in Europe was to replace national sovereignty by a ‘States of Europe’ along federal lines. This goal could only be achieved by functional integration, that is supranational co-operation in specific economic sectors. Monnet was a political pragmatist and realised that if governments decided to pursue this goal, then the decision to do so would have to be taken privately at the ministerial level, rather than by a congress of several hundred people. However according to Monnet, only a crisis would impel the European governments to suppress their political caution and curb their desire to protect national sovereignty and force them to take the necessary steps to implement this approach to European integration. Aware that such a crisis had not yet occurred, Monnet resigned himself to wait until one occurred before he could act.

Economic Integration

Monnet did not have to wait long for a crisis to develop. The Marshall plan had offered aid on a continental basis and the USA viewed the regeneration of Europe as intrinsically linked to the regeneration of Germany. But the French Modernisation plan was based on the continuation of punitive measures against Germany. Any attempt to assist German economic recovery was interpreted by France as a threat to economic recovery and national security.

After the war, the British and USA administrations began to relax their repressive policies toward Germany, but the French government continued with their policies aimed at keeping Germany demilitarised, decentralised and deindustrialised even refusing to merge the French occupation zone with the Anglo-American ‘Bizonia’ in 1947 (Dinan, 1994b, p. 19). The softening of Allied policy toward Germany endangered French economic recovery for two main reasons: France sought ownership of the coal-rich Saar region and control over the Ruhr region to stifle German economic recovery. As long as Britain and USA wished to placate the Soviet Union and preserve the Grand Alliance, then France would have an ally to help block any attempts at rapprochement with Germany. This strategy collapsed after the breakdown of a foreign ministers meeting in March 1947, any desire by Britain and USA to placate the Soviet Union faded and France was presented with a problem regarding its German policy. The Ruhr region fell under the jurisdiction of the British and American authorities and France had no influence over policy formulation. In attempt to claim some control the French controlled zone was merged with the Anglo-American zone to create the Federal Republic of Germany in September 1949, whilst France obtained a concession in the form of the Ruhr International Authority in order to exert some degree of control over industrial production. But this proved a futile attempt by the French, USA

pressed for economic growth in Germany to help European economic recovery. The Western powers also concluded that the German economy must be revitalized to act as a bulwark against Russia (Palmer and Lambert, 1968, pp. 257-8 and Tsoukalis, 1997, p. 11). France was faced with the need to reformulate its policy toward Germany. Monnet immediately saw this as an opportunity which he could exploit.

Monnet approached Robert Schuman, the French Foreign Minister, with his proposal for a supranational coal and steel community. Before making a public announcement, Schuman sought and received German and American support. In May 1950, Schuman made a public statement. The Schuman Plan proposed that German and French coal and steel production be 'pooled' and placed under a common supranational authority.[3] The treaty creating the ECSC was signed in Paris in April 1951 and the process was concluded in July 1952 with the ratification of the treaty by France, Germany, Italy, the Netherlands, Belgium and Luxembourg. Other European countries did not join the ECSC because at the time they did not feel the political need or else argued that international co-operation should take place in the wider setting of the OEEC. For Britain in particular, there was an unpalatable condition placed on participation at the negotiations, the acceptance of the principle of shared sovereignty (Dinan, 1994a, p. 25). The ECSC was a response to the strong drive behind 'the movement for European unity' which was fuelled by 'the memory of the war and . . . the obvious and visible threat of Soviet military power' (Jenkins, foreword to Broad and Jarret, 1972), and was also intended to act as a reconciliatory gesture between France and Germany (Kirschen, Bloch and Basset, 1969, p. 2, and Pinder, 1996, p. 126). Moreover it was also aimed at the eventual achievement of full political and economic union between the participating states.

The ECSC was unique in that it was the first time that institutional structures were established which had supranational powers. The Paris Treaty established an institutional structure for administering, controlling and supervising the tasks defined in the Treaty. There were four main institutions: the High Authority, the Council of Ministers, the Common Assembly and the Court of Justice.

The High Authority was the main institution responsible for the implementation of the Treaty. It had the authority to make legally binding decisions, to fix a Community price system decreeing minimum and maximum prices for certain products and fine firms for breach of ECSC competition rules or failure to implement binding decisions.

The Council of Ministers was composed of the representatives of the member states. The Council was not mentioned in the original plans for the Community, but was added as a check on the powers of the high authority where the member governments were not prepared to surrender national autonomy. Hence, its main task was to ensure the actions of the High Authority were consistent with the wishes of national governments.

The ECSC's assembly had a purely consultative role. It had limited power in that it could only pass censure on the High Authority's annual report which could force the Higher Authority to resign.

The Court of Justice provided a judicial check on the actions of the Higher Authority, governments and individual firms. All judgements were binding.

In addition a Consultative Committee was established, composed of representatives of producers, consumers and workers. It had the right to be consulted by the Higher Authority in most matters.

The ECSC was a limited exercise in economic integration involving only two, albeit important, sectors. A free trade area was created in coal and steel, tariffs and quotas were removed. Free trade in these materials was promoted, so that no country could monopolize them for their own purposes and any individual could purchase the goods if they wished.[4] In this way Germany became free to regenerate its economy while assuaging the fears of other European countries who were concerned that it would use its revitalised economy to become a military power again. At this stage, European monetary integration did not appear to be on the agenda, and this was for two main reasons. First, the Bretton Woods exchange rate system was functioning with stable exchange rates which were not under pressure during the 1950s. Second, many of the European economies which were at the centre of the ECSC were performing in a similar manner in terms of economic growth and inflation (Hitiris, 1988, p. 90). Even though the ECSC was established under an economic pretext, there was, nonetheless, a clear political agenda as stated in the preamble to the Treaty:

> to substitute for their historical rivalries a fusion of essential interests . . . to establish by creating an economic community the foundations of a broad and independent community among people long divided by conflicts; and to lay the basis of institutions capable of giving direction to their future common destiny (Palmer and Lambert, 1968, pp. 167-8).

Political Integration

The beginning of the Korean war increased the possibility of conflict between east and west in Europe, which made the defence of Europe a higher priority for governments. The USA realized that if a confrontation developed with the Soviet Union, then its resources would be stretched. In response to this problem it asked its allies to increase their military expenditure, a request which was firmly rejected (Urwin, 1991, pp. 60-61). The USA were forced to consider other alternatives, and swiftly suggested two changes to the North Atlantic Treaty Organisation (NATO) structure:[5] the rationalization of European armaments and the participation of West Germany. The latter proposal was disturbing for the other European countries since it had been only five year since the end of the war and Europe was still fearful of a re-armed Germany. For this reason, and also inspired by the success of the ECSC, a compromise was agreed, whereby the six members of the ECSC elected to form a federal army called the European Defence Community (EDC). The treaty was signed, with NATO approval, on May 1952. Later the treaty was ratified by all the parliaments with the exception of the French Chamber of Deputies who rejected it in 1954. This was the first setback suffered on the move to European integration and it sealed the fate of a more ambitious plan for a European Political Community (EPC) - the EDC treaty contained an article on the convening of an assembly which would have been charged with the preparation of a European federal constitution.[6] The failure of the EDC signalled the end of active attempts to establish a form of supranational political governance structure, subsequently, the political leaders of the ECSC concluded that the next step for closer union was to be taken in the economic area. There was widespread conviction that the Community system offered more advantages than the traditional intergovernmental formulae, thus the ECSC blueprint was applied at the next stage. At an ECSC conference in Messina in June 1955,[7] the Benelux countries made four proposals, two of which received support, an atomic energy community and a European Common market for all goods and services.

The Treaty of Rome in 1957 lead to the creation of two more communities, the European Atomic Energy Community (Euratom) and the European Economic Community (EEC). European integration had taken a step forward despite the calamitous failure of the EDC and EPC. The two new communities had different experiences. In the early 1960s the Euratom community was hampered by reduced funding when governments diverted money to their own national programmes. Consequently, the Euratom community was marginalised quite quickly. By contrast, the EEC had a much broader agenda, the creation of a common market in all economic sectors through competition without distortion. It is to the EEC that we now turn.

European Economic Community

In addition to the swath of articles of the Treaty of Rome establishing a customs union, Article 4 of the treaty created four main institutions to oversee the EEC. The institutional pattern of the ECSC was copied in the EEC. The decision-making and executive functions are fulfilled by two bodies: the Council of Ministers and the Commission. Yet in key aspects the institutional structure of the EEC Treaty differs from the ECSC Treaty. First, the Council is the primary decision-making body and second, the Commission is responsible for initiating decision-making and fulfills an executive function.

Commission members were selected for their ‘general competence’ and by unanimous agreement of national government. All important matters of policy including the adoption of draft legislation or decisions to be submitted to the Council are taken by the Commission. The Commission has three main duties:

1. Initiator of almost all policy,[8]
2. Executive organ of the community,
3. Custodian of the Treaty.

The Council of Ministers consisted of one minister from each member government authorized to make decisions at ministerial level. Groundwork is completed prior to the decision-making process at the meeting of national experts or by permanent representatives. The Council's executive power are devolved to the Commission in many cases, legislative power is shared with the European Parliament with which it holds joint budgetary authority. Article 104 of the Treaty of Rome gives the Council the power to coordinate the economic policies of member states. Council of Economic and Finance Ministers (ECOFIN) is one such session of the Council of Ministers, it usually meets monthly to discuss the macroeconomic situation in member states, to co-ordinate the Union's position in international financial institutions and to adopt legislation in respect of tax harmonization, financial liberalization and the financing of the Union. The qualified majority system normally applied.

At the heart of the Community system lies the interaction between the Commission and the Council. The Commission plays an active role at Council sessions and is treated on an equal footing. Its derives its power from two channels: the right of initiation and the implication of the voting rules. The Commission puts forward only proposals that it deems fit into the areas covered by the Treaty and it alone selects the timing of the presentation of the proposals to the Council. In areas of policy where unanimity is the rule, the Commission plays the role of 'honest-broker', striving to reach consensus on an acceptable text. It seeks compromise whilst at the same time defending the Community's position.

The Assembly, established by the Treaty of Rome, became known as the European Parliament in 1962. Its members were originally nominated by the parliament of the six member states, but they were not bound by instruction from national parliaments or governments. The EEC Treaty defines the Assembly's powers as 'advisory and supervisory'. Relating to its advisory power is the right to be consulted on budgetary matters, and to recommend action or policies on its own initiative. With its supervisory functions comes the ability to censure the executive and force it to resign, to put questions to members of the executive and Council, and to discuss the executive's annual report. In 1979 members were directly elected to the European Parliament for the first time.

The Court of Justice acts as the final arbiter in disputes arising from community treaties. It was established by ECSC Treaty to 'ensure that in interpretation and application, the law is observed' and its area of competence was extended by the Rome Treaty. The Court's jurisdiction includes the failure of member states to fulfill treaty obligations, judicial review (review the legality of Regulations, Directives or Decisions adopted by the Council of Ministers or the Commission and certain acts of the European Parliament), if the Council, Commission or European Parliament fails to act and in so doing infringes a requirement laid down by the Treaties and if an interpretation of treaty or validity of acts of community institutions are questioned, then the national court can ask the Court to give a preliminary ruling.

Other important institutions are the Economic and Social Committee which is an unelected representative body (employers, trade unions and other interest groups). The Council of Ministers is bound to obtain the Committee's opinion on draft legislation in certain subject areas, though this opinion is not binding. The Monetary Committee was established under the Treaty of Rome (Article 105) as an official-level advisory body to the Council of Ministers in the economic and financial field. It was created to promote the co-ordination of the policies of member countries in monetary matters to the extent necessary to ensure the operation of the common market and was tasked with monitoring monetary and financial situation of member states. In 1964 the Council extended the Committee's work to include co-ordination of the Community's position in international financial institutions.

European Council : These are meetings of the heads of state or of government of the member states of the EC and the president of the European Commission. The Treaty establishing the European communities makes no mention of the European Council. President DeGaulle originally suggested meetings of heads of state and governments as part of his proposal to create a political union (Morgan, 1976, p. 9). Although the proposal was ultimately rejected, it created sufficient interest among the governments of the six member states for them to hold a first meeting of heads of state and government in Paris in February 1961. A later conference in Bonn in July 1961 agreed 'to hold, at regular intervals, meetings whose aim will be to compare views, to concert their policies and to reach common positions in order to further the political union of Europe' (Morgan, 1976, p. 10). At a later meeting in Paris in December 1974 it was agreed that the Council should meet three times a year

with the possibility of special sittings.

Committee of Central Bank Governors (CCBG) : This Committee was first given institutional standing in May 1964 when Ecofin decided to complement the existing Monetary Committee by establishing a body to co-ordinate activities of central banks. The Committee's remit was to hold consultation about broad lines of policy of central banks and exchange information at regular intervals.

The EEC was based on the creation of a common market which was achieved through specific measures outlined in Article 3 of the treaty: the elimination of custom duties and of quantitative restrictions on intra-EEC trade; the establishment of a common external tariff and of a commercial policy toward third countries; the free movement for goods, services, persons, and capital; common policies in agriculture and transport; the introduction of procedures to allow the co-ordination of economic policies, and the rectification of disequilibria in the balance of payments; the establishment of a system to ensure undistorted competition in the common market; the approximation of laws to enable the proper functioning of the common market, and the creation of the European Structural Fund (ESF) and European Investment Bank (EIB) to improve employment opportunities, support economic expansion and raise the standard of living (Jovanovic, 1997, p. 9 and Kirschen, Bloch and Basset, 1969, pp. 9-10).[9] As mentioned above, there were important exceptions, agriculture and transport where areas with a high degree of government intervention and it would not have been practical to remove the barriers, instead a common policy was adopted.

In contrast, the Treaty of Rome was less explicit about macroeconomic policy and monetary policy. Monetary policy was seen as an objective insofar as it facilitated the proper functioning of the common market. However, the Treaty of Rome did detail some general economic and monetary objectives: equilibrium in overall balance of payments, maintenance of confidence in currency, a high level of employment and stable prices (Article 104).

And in order to attain these objectives, three instruments were specified. First, the coordination of economic policy through government and central bank collaboration. In this respect, the Monetary Committee was enjoined with ensuring that member countries complied with this objective. Second, the stabilisation of exchange rates (Article 107). And third, member states had recourse to limited credits and to other unspecified mutual assistance in event of balance of payment problems (Kirschen, Bloch and Basset, 1969, p. 33).

Despite these declared aspirations there were no specific provisions made in the treaty regarding co-ordination in the macroeconomic field. Article 2 refers to the 'harmonious development of economic activities' and to 'a continuous and balanced expansion' but there were not sufficient instruments created to realize these objectives. Regarding the lack of precise instruments for macroeconomic co-ordination, several explanations can be offered. First, Keynesian ideas still held sway and governments wished to retain direct control over fiscal and monetary policies. Second, greater capital mobility across national boundaries would undermine the effectiveness of national monetary instruments. Thirdly, the governments did not wish to push too far in case the whole enterprise was placed in jeopardy (Tsoukalis, 1997, p.13-4). In addition, exchange rate stability and a basic framework for policy co-ordination were provided externally by the Bretton Woods system (Fratianni, and von Hagen, 1992, p.12). Elsewhere the Preamble to the Treaty of Rome mention is made of narrowing the differentials between regions, but it was not until 1972 that the European Regional Development Fund was founded. Twelve years was set as the target for creating a customs union with the possibility of an extension to 15 years. In the event, all tariffs for EC internal trade were eliminated on 1 July 1968, one and a half year before the target date, and at the same time, the common external tariff came into force.

To avoid duplication of work the commissions for the three communities were merged in 1967, the Council of Ministers for the ECSC had already merged with the Councils of the EEC and Euratom in 1958. This move heralded a change in emphasis between the ECSC and the EEC despite the basic institutional pattern remaining unchanged. Under the ECSC, the High Authority had the primary role, having considerable powers of direct action, and only needing the consent of the Council of Ministers in specific areas, whilst under the EEC the most important decisions were made by the Council of Ministers, the Commission's influence derived from its right of initiative. Previously there had been a single community whose sphere of control covered two sectors, now there were three communities co-existing whose interest encompassed most of the economic spectrum. These communities were seen by many as a step on the way toward full economic and political union (Palmer

and Lambert, 1968, p. 167).

Monetary Union

In 1959 and again in 1961 pronouncements by Monnet's Action Committee for the United States of Europe called for monetary integration. In response to a persistent balance of payments surplus with the rest of the world among the EEC members, the CCBG was given a brief to co-ordinate exchange rate management and international monetary policy. In 1962 the EEC commission in 'The Action Programme of the Community for the Second Stage' proposed an adjustable peg exchange rate system and a reserve currency established by the end of the decade (Pinder, 1996, p. 127-8, Snyder, 1998, p.11). Yet these calls went unheeded because exchange rate stability and a framework for macroeconomic policy coordination were provided externally by the Bretton Woods system. That remained the case until the collapse of the international system of fixed exchange rates eventually propelled the community toward monetary integration. Europe's position vis-à-vis the outside world and related loss of control over monetary affairs for internal stabilization purposes which originated the major impetus (Study Group on EMU, 1973, p. 1). Both internal and external factors were important: Economic and Monetary Union (EMU) was born as a result of a convergence of widely different interests, ranging from a German need for 'Westpolitik', to a concern about the customs union and Common Agricultural Policy (CAP), the CAP price system was threatened by the exchange rate fluctuations (Pinder, 1996, p. 128); from the safeguarding of fixed exchange rates to the protection of the community from British entry and the possibility of its dilution into a free trade area, and the need to adopt a common policy vis-à-vis the United States (Tsoukalis, 1977, p. 169).

The speedy implementation of the custom's union coupled with the erosion of the stability of the dollar-centred Bretton Woods system fractured the external exchange rate stability of the EC resulted in calls for monetary union to protect the EC from break-up. The increased monetary instability of the 1960s lead to the Barré Report in 1969, the Commission proposed that to counter currency instability, macroeconomic co-ordination should be improved, and that fluctuation margins around the currencies of the six should be eliminated on the first step towards fusing them into a single currency. In this respect, an early landmark was the decision of the EEC heads of states and governments, at the Hague summit of December 1969, to proceed gradually to EMU, a decision which made monetary integration an explicit Community objective (Hitiris, 1988, p. 92). The goal of a single currency was agreed by Ecofin in February 1970 but differences in opinion among members meant that precise details were not agreed. Instead a special study group under Pierre Werner was established to review EMU in greater detail and to propose a concrete plan for moving ahead. The Werner Report 1971 advocated the movement toward economic and monetary union by 1980. Like the Delors Report which it preceded, it proposed an EMU in three stages. There was a clear view of what monetary union entails:

> "A monetary union implies inside its boundaries the total and irreversible convertibility of currencies, the elimination of margins of fluctuation in exchange rates, the irrevocable fixing of parity rates and the complete liberation of movements of capital . . . monetary union . . . may be accompanied by the maintenance of national monetary symbols or the establishment of a sole Community currency. From the technical point of view the choice between these two solutions may seem immaterial, but consideration of a psychological and political nature militate in favour of the adoption of a sole currency which would confirm the irreversibility of the venture" (Werner Report, 1970, p. 5)

The first stage, which was intended to last from 1971 to 1973, was directed at getting economic underpinning right and preparing the ground for any institutional development in order to facilitate coordinated policy-making. The second stage consolidated economic and institutional progress of the previous stage. At this stage exchange rate changes could only be made with the explicit agreement of members. The first two stages would see increased policy co-ordination leading to convergence, a common policy on government budgeting, and a progressive narrowing of currency fluctuation bands. Institutional tinkering would, however, be kept to a minimum, although the European Monetary Cooperation Fund (EMCF) would be created in stage 2 to manage a proportion of the member states reserves and to provide short- and medium-term finance for intervention. The EMCF was responsible to the Committee of Central Bank Governors, which itself was charged with co-ordinating monetary and exchange rate policy. Ecofin would meet more regularly to co-ordinate macroeconomic policy. Co-ordination entailed the prescribing of medium-term objectives and of

annual programmes which were to be based on multilateral surveillance. And in stage 3 exchange rates would be irrevocably fixed and a community central bank would be created to centralise monetary policy.

Opposition to these measures came from the Gaullists in France which ensured that progress would have to be mindful of French sensitivities. As a result institutional consolidation would have to be evolutionary and cautious - France would only assent to a managed currency arrangement. In addition, a dispute raged over which strategy to adopt to achieve economic and monetary union. One group, represented by France, Belgium and Luxembourg, wanted to lock into irrevocably fixed exchange rate parities as soon as possible, even before the effectiveness of economic policy co-ordination had been established. Another group represented by West Germany and the Netherlands, wished to establish a system of economic policy co-ordination before eventually progressing to a fixed exchange rate. Ultimately, the Werner Report reached a compromise between both position by developing a strategy of parallelism for economic policy co-ordination and for monetary union.

In March 1971 the Ecofin Council agreed on EMU, although only stage 1 was elaborated. Mechanisms for closer co-operation among central banks were agreed. An 'opt-out' clause was included if agreement on the second and more substantive stage of EMU was not reached by January 1976, then monetary co-operation measures should be abandoned. The notion of irrevocably locking exchange rates together without any margin of fluctuation, as suggested in the Werner report, was abandoned in favour of a mechanism to reduce the margin of fluctuation around the central parities when one EEC currency was exchanged for another. Intra-EEC exchanges were confined to a narrower band of fluctuation than was permitted in respect of EEC currencies against the dollar (the 'snake in the tunnel'). This attempt to limit intra-European exchange rates would serve to advance the objective of EMU by promoting trade in goods and services and capital flows within Europe. In addition it would help to reduce the cost of servicing the CAP, the Community's agricultural support system (Klein, 1988, p. 5).

The emerging economic conditions of the early 1970s were impropitious to establishing EMU. Faced with rising unemployment and slow economic growth, the USA pursued an easy monetary policy which was the converse of that desired by the authorities in European countries. The tensions created by these divergent policies eventually lead to a series of speculative attacks again the dollar. The launch of EMU was cancelled because of the economic instability. The dollar rescinded its gold convertibility in August 1971. And, finally the Bretton Woods system collapsed in December 1971 when the G7 nations agreed the Smithsonian accord to allow a 4.5% band of fluctuation against the dollar and 9% bilaterally.[11] After the collapse of the Bretton Woods system the 'snake' was introduced in April 1972, only to be replaced by the 'floating snake' when the dollar floated in December 1973.[12] But the attempt to preserve some of the elements of Bretton Wood at the regional level proved to be a futile exercise. The snake was quickly transformed into a Deutschmark zone after the withdrawal of sterling, the punt, the lira, and the French franc.

Progress toward EMU was persistently hampered: first, the shocks to the international monetary system that followed the dollar crisis in 1971-73, and the first oil crisis and inflationary push of 1973; and, second, conflicting national objectives and unwillingness to surrender national sovereignty in pursuit of a Community objective. Circumstances had dictated that the lowest common denominator solution be agreed, thus the EC countries settled on a common goal of economic and monetary union and a weak mechanism for exchange rate control (Kruse, 1980, ch. 9 and Pinder, 1996, p. 129). The 'snake' did not succeed in its explicit aim of creating a zone of monetary stability (Tsoukalis, 1997, p. 38). With the collapse of the Bretton Woods system and the floating dollar, the process of EMU ground to a halt. When the Commission eventually came round to consider proceeding to stage 2, no agreement could be reached at the Ecofin Council and EMU was abandoned in December 1974.

Dissenting voices had argued against speedy monetary union. The Marjolin Report (1975) argued that monetary union should be postponed until after the achievement of a high degree of economic integration in the EC. It advocated that a single unified market would provide a sound basis from which to launch monetary union. From another standpoint, the MacDougall Report (1977) stressed the role of a unified fiscal system in a monetary union and concluded that a monetary union would not be viable without a sufficiently large community budget for fiscal policy (Fratianni and von Hagen, 1992, p. 13). From its inception the 'snake' was beset with problems and burdened with an inherent asymmetry. It placed the burden of adjustment on the weak-currency countries and was unable to provide adequate financing for weak-currency central banks when

their currency was subject to currency speculation (Klein 1998, p. 5). By 1979, only Germany, Netherlands, Denmark, Norway, Sweden, Belgium and Luxembourg remained within the fixed exchange rate system.

The EMU project did have concrete achievements and it would serve as a blueprint for those proposing EMU in the future. Foremost among these achievements were the strengthened co-operation among central banks with the creation of the EMCF and the agreement on the attainment of a high level of convergence of the economic policies of member states. It highlighted the economic and political difficulties associated with such moves towards EMU. It also demonstrated that a sustained record of stable currency management was an indispensable precondition for any serious attempt to adopt a single currency, vague commitments without a firm timetable fixed in advance were no good, no lasting progress towards EMU could be achieved without appropriate institution reforms guaranteeing a transfer of responsibility in the macroeconomic field from nation to European level.

The European Monetary System

In 1977 Roy Jenkins, President of the Commission, reactivated plans for establishing a monetary union. Support for his plan was provided by a Franco-German alliance without which it would have been an non-starter.[13] In July 1978, the heads of state of the member countries, the original six plus three new entrants (UK, Ireland and Denmark), met to discuss closer monetary co-operation. The European Council adopted a resolution establishing the European Monetary System (EMS) later that year. A new attempt at establishing monetary stability was launched in March 1979 with the EMS replacing the ‘snake’. The second stage, the creation of the European Monetary Fund to replace the EMCF was planned for two years later, however, the deteriorating economic climate put this move on hold. The EMS was established to pursue three main policy objectives: the creation of a ‘zone of monetary stability’ involving both low inflation and stable exchange rates; the provision of a framework for improved economic policy co-operation between member states; and the easing of world monetary instability through the adoption of common policies in relation to third countries (European Commission, 1989, p. 2). Finally, it was hoped that the EMS would lead to economic and monetary convergence, and ultimately a stepping stone to economic and monetary union. It introduced innovations to overcome problems that had lead to the collapse of the ‘snake’. The divergence indicator, as discussed below, was created to counter excessive German dominance and establish symmetry. Realignments were to occur only after unanimous agreement not taken as a unilateral decision as was the general rule under the ‘snake’. This procedure was introduced to prevent countries harming the system by taking actions only in their self-interest.

To realize these objectives the EMS provides a tool called the Exchange Rate Mechanism (ERM) which consisted of four components: European Currency Unit (ECU), the parity grid, the divergence indicator, and credit financing. First, the ECU had two uses: monetary unit based on a basket of EU currencies; a fixed quantity of each currency in the basket with the weights of the currencies vary over time as intra-European exchange rates fluctuate, and a reserve instrument issued by the EMCF to the EMS central banks in exchange for 20% of gold and dollar reserves. The EMCF was first set up in 1973 as part of the attempt to establish monetary union. The failure of the first attempt at EMU in the mid-1970s and the subsequent reduction in the membership of the ‘snake’ to a small block of countries diminished the role envisaged for the EMCF. However, the new attempt at establishing a monetary system saw its relaunch as a part of the EMS. Second, the parity grid is made of a central rate, bicentral rate and marginal intervention. The parity grid tied each currency to every other currency in a system of mutually agreed exchange rates. When one currency diverged from parity, all other exchange rates also diverge, hence all countries must respond through intervention to re-establish parity. The central rate is the amount of a country’s currency equal to one ECU and is only revised by unanimous agreement of participating governments. The central rates, determined the bilateral exchange rates, with fluctuation bands set at ±2.5% and ±6% for Italy, when the currency reaches this limit the central bank must intervene. Under the EMS, once either the upper or lower limit was reached, it signalled the need for intervention by the central banks. However, the EMS was designed not to be a rigid system but adjustable to changing economic conditions and the economic performance of member countries. Third, the divergence indicator is used to give a warning when a country is diverging from its central rate. The divergence indicator acted as a supplementary intervention device. When movements in the daily exchange rate pegged against the weighted average movement of the other EMS currencies exceeded 75% of the maximum possible divergence spread, it signalled the need for a country’s monetary authority to take corrective measures: diversified intervention (intervention in a range of currencies, rather than in a single currency), domestic monetary policy

(which would have an effect on interest rates), changes in central parity, or other measures of economic policy (fiscal or incomes policies). The divergence indicator applies equally to relatively weak and strong currencies with the intention of introducing symmetry into the EMS. Accordingly, there would be equal sharing of the adjustment of balance of payment disequilibria between deficit and surplus countries. Fourth, credit facilities which are made available to ERM members for intervention in the foreign exchange market. Three types of finance facility are provided to member countries to intervene in the foreign exchange markets once their currency approaches the upper or lower limits of their exchange rate band. Very short term (45 days - 3 months) and short term (3 - 9 months), which are administered by central banks, and medium-term (2 - 5 years) administered by the Council of Ministers (Kondonassis and Malliaris, 1994, p. 296).

The members of the European Community participating in the ERM (the UK remained outside the ERM until October 1990) chose to fix their bilateral exchange rates, but did try to co-ordinate their monetary policy. Nevertheless, monetary policy was geared toward maintaining their exchange rate. The optimists argued that the stability of the exchange rates between member countries would promote economic trade and growth, and the more inflationary economies would have to move to lower inflation rates. Eventually the EMS would increase the interdependence of European countries by providing a tool for exchange rate stabilization and for encouraging convergence of economic and monetary policies (Kondonassis and Malliaris, 1994, pp. 295-6). It was described as ‘a fundamental component of a more comprehensive strategy aimed at lasting growth with stability, a progressive return to full employment, the harmonization of living standards and the lessening of regional disparities’ (Jovanovic, 1997). The EMS was implemented by agreement between central banks of the Community, which implied that the CCBG became the routine management agency for intervention within the ERM. From 1974 the Monetary Committee was consulted on alterations in a currency’s exchange-rate parity. This function was carried over to the EMS. Obligatory consultation of the committee in matters on capital liberalization and emergency balance of payment loans or assistance extended to individual member states.

Even at an early stage there were concerns raised about the viability of the EMS. The EMS faced the asymmetry problem of a fixed exchange rate system that deficit countries are under pressure to deflate but surplus countries are not under similar pressure to reflate. When two currencies reached their agreed limits, both countries had to intervene in the strong currency to buy the weak currency. The weak currency country could use the very short term facility to fund intervention. But a problem existed when a currency approached its lower limit, speculators would enter the foreign exchange market selling the over-valued currency, this would force the weak country to intervene before the currency reached its limit. This intramarginal intervention was discretionary and the strong currency country was not bound to take action, nor was very short term facility available. The full burden of adjustment falls on the weak currency. The rules of the EMS may have been constructed to insure that the immediate effects of intervention were perfectly symmetric. However, the final liquidity effects need not be symmetric. Central banks sterilize foreign exchange interventions and the EMS does not legislate in this respect. This gives rise to asymmetry because hard currency countries find it easier to secure the large amounts of foreign currency required to engage in sterilised intervention than weak currency countries. Asymmetry in the system was aggravated further by two other factors: intramarginal intervention which far exceeded formal obligatory intervention and the lack of a common policy toward the dollar. The EMS was also susceptible to disruptive capital flows as the dollar weakened the DM replaced it as a reserve currency, causing the DM to appreciate within the EMS and further destabilising the system. This highlighted the degree of interdependence in the world economy - the EMS experienced shocks even though the developments occurred elsewhere in the world.

As we mentioned above, the introduction of this new exchange rate system occurred against the backdrop of large inflation differentials between participating countries. Changes in relative prices between countries shift competitiveness. Between 1979 and 1987, there were eleven realignments within the ERM. These realignment were by high inflation countries devaluing their currencies to remain competitive with the low inflation countries. Countries were forced to implement capital controls to prevent the destabilising effects of capital flows. This highlighted the fundamental weakness of the ERM, a fixed exchange rate system operating without the coordination of monetary and fiscal policies.

When in 1986 the EU amended the Treaty of Rome with the Single European Act, the end of 1992 was set as a target date for the removal of all remaining barriers to the free flow of goods, services and resources. A greater degree of macroeconomic co-ordination among member states was now required. As a consequence of which,

the EMS was strengthened because of the desire to achieve greater convergence in economic policies, the Basle/Nyborg agreement was reached in 1987. This introduces a series of measures aimed at promoting the co-ordination of economic policies through the surveillance of economic indicators and the refinement of the EMS intervention mechanism to counter speculation after capital liberlisation. The very short term credit facility would be available for intramarginal intervention.

Between 1987 and 1992 there was only one re-alignment, a 3.7% technical depreciation of the Italian Lira to allow for the narrowing of the fluctuation margin. Other countries became members of the ERM, Spain in June 1989, the UK eventually deciding to join the ERM in October 1990 and Portugal in April 1992: all the currencies participated in the 6% band. At last the EMS appeared to realise its purpose, variations in the real exchange rates and money supplies among EMS members (Germany, France and Italy) were smaller than non-members (Japan, UK and USA) between 1979 and 1988 (MacDonald and Taylor, 1991). And among EMS members, there was convergence in inflation rates, interest rates, budget deficits and government debt as a percentage of GDP between 1987-92 (Salvatore, 1996, p. 605). By July 1990, all restrictions to intra-community capital movements were removed and by the beginning of 1993 all remaining restrictions to the free flow of goods, services and labour were eliminated, the single market was in existence. The status quo, however, could not remain unchanged: a fixed exchange rate system is only compatible with the free flow of capital if macroeconomic policy is fully coordinated.

Until 1992, it appeared that the EMS was an unqualified success, however, the system had not weathered a crisis. There was a suspicion that a large aggregate demand shock would unsettle the whole system, and in 1992 the system was about to be tested. This criticism may seem unfair, the EMS had weathered the oil shock of 1979 after its initial creation, it must be remembered that a similar event hastened the demise of its predecessor, the ‘snake’. Germany was grappling with the cost of financing the restructuring of East Germany, and had historically high interest rates to curb inflationary pressure. Tight monetary policy in Germany acted as a trigger for the ERM crisis. But pressures had been building up in the EMS since the signing of the Maastricht Treaty and the subsequent failure by Denmark to ratify it due the no vote in their referendum. Financial market liberalisation and unfettered capital flows coupled with the EMS required full monetary policy co-ordination. In the financial markets, there was a lack of sufficient credibility in the consistency and co-ordination of economic policy and a general feeling that central bank power would of strong currency countries would be used with discretion (Giordano and Persaud, 1996, p.17).

Faced with the strain of keeping their currencies within their respective bands, the UK and Italy were forced to abandon the ERM. This was followed by six other devaluations: the Peseta in September 1992; the Escudo and Peseta in May 1993; the Punt in January 1993, and again the Peseta and Escudo in May 1993. France remained within the ERM only after heavy intervention in the foreign currency market by the Bundesbank and the Bank of France. Pressure was eased in the Spring of 1993 when the Bundesbank made three interest rate reductions. Respite was only temporary and when the Bundesbank failed to lower the interest rate in August 1993 as was expected, it started a run on the Franc and the currencies of Denmark, Spain, Portugal and Belgium. In spite of foreign exchange market intervention on a massive scale, defeat was accepted and the narrow band of 2.25% was abandoned in favour of 15%. The crisis highlighted the effects of member countries operating unco-ordinated monetary policies. Germany had ignored the warning of other ERM members and had adopted a high interest rate policy in the face of a growing money supply. The ERM was a free floating system in all but name and it appeared that the move toward monetary integration had been permanently derailed. Although at the end of 1996 all ERM currencies with the exception of the Irish punt were within the 2.25% band, while sterling and the drachma remained outside the ERM.

In summary, the attempt to create a monetary union, EMS and direct elections to the European parliament could be pointed to as the defining moments of the period.[14] The EMS seemed to have succeeded in promoting convergence in inflation rates, interest rates, budget deficits and government debt as percentage of GDP from 1987 to 1992 (Salvatore, 1996, p. 605), although Fratianni and von Hagen (1992, pp. 30-31) point out that the inflation performance of EMS countries has been no better than non-EMS countries. In this regard, realignments changed from being a passive reaction to inflation to being an instrument to control inflation and used in conjunction with domestic measures.

The Single Market and the Single European Act

The EC had emerged from the 1970s intact but considerably weakened. The decision-making process was paralysed, the cost of CAP was spiralling out of control, the commission was impotent and the Community's solidarity was strained by national politicians, who only seemed to have national interests at heart (Dinan, 1994, pp. 99-100). In the early 1980s, the Community was characterized by a paralyzed decision-making process, a feeble commission and agricultural expenditure out of control (Dinan, 1994, p. 14). Slowly, however, things began to change. The accession of Greece and the pending accession of Spain and Portugal generated pressure for institutional reform. Direct elections had sent a new breed of vibrant and energetic politicians to the European Parliament who sought to broaden and strengthen the scope of the Parliament's powers. All these factors helped to create a new momentum in Europe for change. Early results were a resolution to the British budget question,[15] and a renewed effort to implement the single market. The single market programme, in particular, was to herald a sea change in the fortunes of the EC.

In the early 1980s, recession had hit the European economies hard, with it came the winds of change bringing a new ideology to Western Europe. The tenets of this ideology were deregulation and neo-liberal theory. In USA, President Reagan and in Britain, Prime Minister Thatcher were applying these doctrines in the belief that they would restrain inflation and reinvigorate the economy. Interest in the completion of the single market among the new ideologues was inspired by the notion that liberalisation of the markets would improve efficiency and promote growth. The neo-liberal politicians were not alone in this respect; business leaders were also supportive of a single market, though they doubted the Commissions ability to deliver one (Dinan, 1994, p. 138).

Despite the doubts, the Commission played a key role in promoting the single market as evidenced by the encouragement it gave to technological collaboration in the Community. High technology was an area that would clearly benefit from the single market (due economies of scale and gains associated with learning curves), yet it was in these areas where no common market existed. Apart from the fiscal, physical and technical barriers preventing cross-border trade, national public procurement practices was another problem with which the high technology industry had to contend. Governments would direct purchases towards national champions. Financial support to national champions was also provided in the form of state aid (Vickerman, 1992 ,p. 130). Considerable headway was made in addressing the issue of competitiveness when leading firms in the electronics industry launched the European Strategy Programme for Research and Development in Information Technology (ESPRIT) in order to promote closer intra-European R&D and to end the fragmentation of the single market (Tsoukalis, 1997, p. 36). This approach provided the template for other similar schemes and lead to a proliferation of joint R&D programmes. Moreover, the ESPRIT programme demonstrated that the Commission could be a constructive partner and an agent for economic revival. It also helped to cast aside persistent doubt on the Commission's capability to deliver a single market.

Europe's loss of competitiveness and the subsequent loss in jobs and rise in unemployment was linked, in part, to the fragmentation of the European market due to the existence of non-tariff barriers. Despite tariff elimination the single market was still fragmented by non-tariff barriers. The White Paper, the Cockfield Report of June 1985 was a supply oriented 'Programme for the completing of the Internal Market'. It tackled the issues involved in dismantling non-tariff barriers and creating a genuine and homogenous frontier-free internal market by 1992. The 1992 Programme was widely accepted and seen as a panacea for Euroscelerosis and an added boost to integration. The main aspects off the programme were the removal of non-tariff barriers for internal trade, increased competition, promotion of cooperation among firms in R&D, unification of factor markets through liberalization of factor mobility, monetary integration and social protection (Javanovic, 1997, p. 16).

On its own the White Paper was not sufficient to guarantee the completion of the single market, it would undoubtedly have become bogged down in procedural wrangling in the Council of Ministers. The Single Market Programme highlighted the need for institutional and constitutional reform of the Community as did the assertiveness of the newly elected European Parliament and the accession of Spain and Portugal.[16] This provided the required impetus for reform resulting in the Intergovernmental Conference that lead to the Single European Act. Another force for change which placed institutional reform on the agenda was the Dooge Report which identified 'priority objectives' to realise European union. These were a homogeneous internal economic area, restrictions on the use of unanimity in the Council of Ministers, enhanced legislative role for the European

Parliament and greater executive power for the Commission (Dinan, 1994, p. 142)

The SEA advocated the adoption of measures which would bring about an integrated internal market ensuring the free movement of goods, services and resources by December 1992 and recognised that the smooth implementation of the 1992 Programme required a change in the decision-making process of the EC. The subsequent reform of the Treaty of Rome by the Single European Act (1 July 1987) helped speed up the 1992 programme. The SEA extended the use of majority voting to most areas except for fiscal matters, rights of employees and free movement of people, thereby sweeping aside the Luxembourg Compromise.[17] This seemed to shift the balance of power to the EC from the national governments: the Council of Ministers got new powers to act on a qualified majority basis after consultation with the European Parliament and the Economic and Social Committee; the Commission gained in importance as it had to prepare proposals for the Council of Ministers to realize the 1992 Programme; and the European Council was formalised. The Single European Act was the community's response to demands for institutional reform and was the first major amendment to the Treaty of Rome. It gave formal recognition to the European Council and formalised procedures known as European Political Cooperation.[18] The Single Market Programme was initially realized quickly but got bogged down in legislation field not only was the problem in the detail, but over the Community's budget. To fulfill expansion in budget expenditure created by the Cohesion Fund, the Commission arrived at a 5 year budget plan in 1988 (Delors I). But, the Single European Act was more than a simple device to achieve a Single Market: 'The 1992 goal was clearly intended as completion, but new policies had been substantively embraced and institutions had been strengthened, this deepening was in hand, and widening had occurred for a third time without momentum being lost' (Wallace, 1989, cited in Dinan, 1994, p. 18). At the end of 1995, the Commission estimated that 93.2% of SEA directives had been implemented by member states. However, in important areas such as public procurement the figure remained below that level (El-Agraa, 1998, p. 158).

The SEA focuses on economic integration and does not explicitly mention EMU except through the need to converge economic and monetary policies 'for further development of the community'. To this end the Delors Committee was set up to examine ways of achieving EMU. The EMS was established primarily to create monetary stability, but it should also be seen as an attempt to move the Community towards the goal of a monetary union. Therefore the SEA should be seen as the economic complement to the EMS and both could be described as stepping stones to monetary union.

The Delors Report

When Jacques Delors took up his position as President of the Commission in 1985, he had a number of priorities: a single market, institutional reform, new monetary initiative and extending Community's competence in the field of foreign policy and defence (Dinan, 1994, p. 17). Delors would have preferred to concentrate on EMU but realised that monetary policy lay too close to the core of national sovereignty. If he choose to follow such a politically sensitive strategy, then it would have provoked hostility from national governments and created tensions within the community. Instead he sought a shared problem where consensus could be reached on achieving a solution. At the time a common shared problem was recession hit economies, Europe had experienced the worst recession since the war. European industry was losing its competitiveness against American firms in new technologies and newly industrialized countries in old ones. There was an common agreed solution, the completion of the Single market, the establishment of a common market had stimulated the economies of the original six, non-tariff barriers had since fragmented the single market, the completion of the single market would do similarly now. Delors recognized quite quickly that the single market was the obvious option. It was simply reaffirming an objective that had been agreed by the heads of states under the Treaty of Rome. Moreover, successful implementation of the Single Market could be a mechanism for improving decision-making and renewing interest in EMU. The momentum created by the Single Market Programme and the success of the EMS in achieving monetary stability did focus attention back onto EMU. And at the European Summit in Hanover on June 1988, the heads of government agreed to establish a committee with 'the task of studying and proposing concrete stages leading towards this union'. The committee delivered its findings in the Delors Report, the following year, at the Madrid Summit.

The report identified four key elements to achieve economic union. First, the creation of a single market; second, competition policy to strengthen the market mechanism; third, macroeconomic policy coordination

coupled with binding rules for budget deficits; and, fourth, common policies to strengthen structural change and regional change. Economic union would not require a single economic policy. By contrast monetary union would necessitate a common monetary policy to be controlled by a central institution, though a single currency was not mandatory. Prerequisites for monetary union were identified as the total and irreversible convertibility of currencies, the complete liberalization of capital transactions, elimination of margins of fluctuation and the irrevocable fixing of exchange rate parities. The central institution overseeing the Community's monetary policy was a European System of Central Bank (ESCB) based on federal lines, which would formulate and implement policy. Its primary objective would be price stability while it would maintain total independence from member states.

The report recommended a transition towards full monetary union in three stages. To insure momentum the transition would be a single process. The first stage defined as an initiation process towards EMU, advocated the convergence of economic performance and cooperation in monetary and fiscal polices. The common market to be completed by the removal of all restrictions to intra-community capital movements, in principle all countries should enter the ERM at the narrow band and measures to encourage convergence of key macroeconomic indicators. It also addressed the issue of non-participating states in the ERM. An Intergovernmental Conference would be convened at a later date to determine treaty revisions that would be needed in subsequent stages. This stage would see the expansion of the role of the Committee of Central Bank Governors in coordinating policy. The organization and the remit of the committee would be redefined and an economic unit was added. The committee chairman was permitted to attend Ecofin meetings, otherwise the institutional structure was sufficient to fulfill the requirements of the first stage.

The second stage was a transitionary period where consolidation of procedures established in stage one would take place and an institutional framework created. Policy would still remain in the hands of national government, though policy guidelines would be mandated by majority voting. A framework would be established for key economic objectives with a monitoring function, for setting non-binding rules on the size of annual budget deficits and for the EC to behave as a bloc in matters relating to economic and exchange rate. A European System of Central Banks (ESCB) which would coordinate the independent monetary policies of member states. The ESCB would also seek to achieve harmonization of supervisory and regulatory functions.

The third and final stage would begin with the irrevocable fixing of participating states' exchange rates whilst national central banks would relinquish control of the domestic money supply to the EC institutions. Eventually national currencies would be replaced by a single currency. Other key developments were that macroeconomic and budgetary rules and procedures would become binding, structural and regional policies would be strengthened. The ESCB would pursue a single monetary policy that would entail engaging in foreign exchange market interventions and union-wide open market operations, formulation and implementation of monetary policy, and the technical preparation necessary for a single currency.

The first stage was adopted unanimously by the European Council at the Madrid Summit in June 1989 and began on 1 July 1990, timed to coincide with the liberalisation of capital movements as part of the Single Market Programme. After agreement at Maastricht on a new treaty to delegate responsibility for monetary policy to a new common institute, the second stage began on the 1 January 1994. The European Monetary Institute (EMI) was created to assume a coordinating role. The EMI was set up as a precursor to the ECB - the central institution of stage III. The EMI's role is to strengthen cooperation between central banks and the coordination of monetary policies of member states, to monitor the functioning of the EMS, to take over the tasks of the EMCF and to facilitate the use of the ECU and oversee its development. In addition it has the general responsibility to make preparations for stage III of EMU. In so doing it should draw up recommendations on the overall orientation of monetary policy and exchange rate policy, policies which might affect the internal or external monetary situation and to members concerning the conduct of their monetary policy. The Monetary Committee assists in monitoring economic convergence at stage II and becomes the Economic and Financial Committee at the beginning of stage III. Member countries (except Denmark and the UK) were required to take measures to make their central banks independent. The third stage, the completion of full monetary union by either 1997, if a majority of the countries meet convergence criteria, or 1999 even if only a minority of countries meet the criteria, would see the Maastricht Treaty and the creation of the European Monetary Institute (EMI) which was the forerunner of the European Central Bank (ECB) by 1994. And finally, in May 1998 the European Council was to met to announce which countries met the necessary

conditions for the adoption of a single currency. the third and final stage of EMU would begin on 1 January 1999. It would see participating states adopt 'irrevocably fixed' exchange rate, the Euro would be substituted for national currencies, and the ECB would become the sole issuing authority for Euro notes. In addition the creation of the ESCB, composed of ECB and national central banks, to replace the EMI.

Maastricht and Beyond

The period leading up to the Intergovermental Conference on EMU was one of cheerful optimism, the Single Market was nearing completion, and European economies were buoyant. The Rome Summit in December 1990 launched a year long process of intensive bargaining. And eventually at Maastricht the Treaty on European Union was signed in December 1991, establishing a union which consisted of three pillars: the Treaty of Rome, the Common Foreign and Security Policy, and cooperation on Justice and Home affairs. In addition majority voting on implementing decisions and unanimous on principle were accepted. The Maastricht Treaty was a political compromise where each country gave some ground in order to gain some movement on an objective. In a nutshell the Maastricht Treaty can be shown to reflect this compromise. The single currency and defence and foreign policy arrangements satisfied France's ambitions, The increase in the power of the European Parliament and the direction of the money policy was German inspired. The cohesion fund and the Social Chapter was included to satisfy Spain and the Netherlands respectively. Britain secured two opt-outs, one from the social chapter and one for the single currency (Javanovic, 1997, p. 16). Maastricht was also a compromise in other respects; for those who wished to set a ceiling on integration by emphasizing subsidiarity and intergovernmentalism and those who wished to strengthen European union (Wallace, 1994, p. 64).

At Maastricht, greater detail was added to the process towards economic and monetary union, which was seen as a means to 'promote economic and social progress which is balanced and sustainable'. The Maastricht Treaty added to the Treaty of Rome and setup a number of new institutions as well as specifying the stages by which EMU was to be achieved. EMU was not seen as a means in itself rather as a means of securing 'economic and social progress' (Article B TEU) and 'price stability' (Article 3a EEC). The underlying argument behind this assumes that the efficiencies and benefits from a single market (economic union) will only be maximized when the costs and risks of currency exchange are eliminated (monetary union).

The Maastricht Treaty adopted the Delors three stage plan with some important revisions. At stage II, the EMI would replace the CCBG and inherit the duties of EMCF. Agreement was reached to set strict criteria which would have to be met before a nation had to join the final stage of monetary union.

1. Average exchange rate not to deviate by more than 2.25% from its central rate for the two years prior to membership;
2. Inflation rate was not to exceed the average rate of inflation of the three community nations with the lowest inflation rate by 1.5%;
3. Long-term interest rates not to exceed the average interest rate of the three countries with the lowest inflation rate by 2%;
4. Budget deficit not to exceed 3% of its GDP;
5. Overall government debt not to exceed 60% of its GDP.

As well as the five conditions above, there was a provision made for the European Commission and the EMI to make regular reports to the Ecofin Council on the economic performance of the member states regarding the convergence criteria. Ecofin's responsibilities were extended by the Maastricht Treaty which gave it a supervisory role, in collaboration with EMI, of the progress towards EMU.

The European System of Central Banks (ESCB) and European Central Bank (ECB) are to assume responsibility for monetary policy in the Euro zone at the beginning of stage III. Article 105 of the Maastricht Treaty enjoins the ECB with the primary objective 'to maintain price stability . . . smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system'. The ECB has the general right of consultation on all legislation, European or national, in its area of competence.

The year 1992 was supposed to have been a triumph for the EC, it was to begin with steps towards ratification

of the Maastricht treaty and to end with the completion of the Single Market Programme. Instead currency crises hit the EMS in 1992 and again in 1993 seemed to have permanently derailed monetary union. And a series of events unfolded which caused set backs on the road to EMU: concern over loss of sovereignty and democratic deficit in Brussels, compounded by pending recession and EMS currency crisis, ratification problems in some countries (Danish referendum defeat of June 1992, and difficulties ratifying the Treaty on European Union in the UK) and war in the former Yugoslavia. However, this prognosis was soon to appear premature as the nations pushed for monetary union with greater vigour and the start of full monetary union was merely postponed from 1997 to 1999.

At the insistence of the German government, the Dublin Summit in December 1996 introduced the Stability and Growth Pact, and this Pact ensured the continuation of limits on budget deficits in member countries. This provided the detail to an otherwise vague recommendation on excessive deficits in the Maastricht Treaty. It specified limits for deficits and procedure to follow in case limits are exceeded and outlined the sanctions that the deficit country would incur if it breached the limits though it did provide automatic and discretion exemptions under certain conditions. Also at the Dublin Summit meeting, arrangements were made for ERM II, which outlined the exchange rate system for countries who had opted out of third stage or did not meet the Maastricht criteria.

In May 1998, the European Council selected the countries qualified to participate in Stage III of EMU. Their decisions were based on reports, submitted by the EMI and European Commission submitted in March 1988, assessed how each country had complied with the convergence criteria. In June 1998, the ECB replaced the EMI and on January 1999, it will take over responsibility for monetary policy within the Euro zone.

The Maastricht Treaty, which provides the institutional framework for the introduction of the single currency was laid down, was signed in late 1991, which was a time when neo-liberal ideas held sway and when political power was generally held by the right. Neo-liberal ideas still prevail, though perhaps in some decline as evidenced by the electoral victories of the left of centre parties in France and Germany. But the neo-liberal agenda has moulded the environment within which the euro will be introduced. The euro (at least for those 11 countries which have signed up) is embedded within an institutional and policy setting which we have elsewhere described as ‘new monetarism’.

Conclusion

Since the establishment of ECSC, the economies of member states have slowly integrated. The economics environment which existed in the 1950s is a far cry from the integrated European Community of today. In the 1950s, European currencies were not convertible and domestic trade was highly protected. Intra-European trade was based on bilateral clearing arrangements institutionalised by the European Payments Union. Today EU currencies are fully convertible. Capital controls, intra-EU tariffs and quotas have been eliminated, and the single market has been completed. EU currency have become relatively stable under the discipline provided by the ERM. Soon the ECB will be determine monetary policy for the Euro area. And the ERM II will provide the framework for stability between Euro area currencies and the currencies of other EC states remaining outside the Euro zone.

Notes

1. This monetary union experiment lasted from 1865-1925, when instability after the First World War lead to its demise. Each country’s coins were made legal tender throughout the member territories (Bainbridge and Teasdale, 1995).
2. The European Convention for the Protection of Human Rights and Fundamental Freedoms which establishes the Court of Human Rights came into effect in September 1953 as a recommendation of the assembly in September 1949.
3. There was considerable fear of an uncontrolled revival of the Ruhr heavy industries, which might once again serve aggressive national policies. France offered to relinquish full control over her own industries in return for a measure of European control over German industry. Coal and steel were chosen for political and economic reasons - the two industries were essential to any war effort and to the modern industrialized economy (Palmer and Lambert, 1968, p. 290).

4. The Treaty of Paris was intended to eliminate barriers to trade and encourage competition in the two sector, however, anomalies still existed which is not surprising given the history of the two sectors - Belgian Coal and Italian steel were exempt from some of the conditions imposed through membership of the ECSC.

5. The treaty establishing the North Atlantic Treaty Organisation (NATO) was signed by the foreign ministers of Belgium, Britain, Canada, Denmark, France, Iceland, Italy, Luxembourg, the Netherlands, Norway, Portugal, and USA in April 1949.

6. The Pleven Plan for EDC in 1950 gave rise to the suggestion that the federal army proposed by the plan should be under the control of an elected supranational authority - the EPC was the proposed authority.

7. Britain was in attendance as well as the six members of the ECSC, however, it withdrew after only a few months when it realized that its proposals for a free trade area within the OEEC framework would not be accepted by the others who advocated further economic integration along supranational lines.

8. In rare cases the Council of Ministers can also initiate policy.

9. So far as capital movements were concerned the degree of liberalization was 'to the extent necessary to ensure the proper functioning of the common market' (Tsoukalis, 1997, p.14).

10. There were few specific provision made for regional policy and industrial policy apart from the European Investment Bank and the European Social Fund, even these were designed to operate in the Mediterranean member countries.

11. There were strains on the Bretton Woods system throughout the 1960s, the sustained growth in dollar liabilities relative to gold stocks created a crisis of confidence over convertibility. By 1968, gold convertibility had for all intents and purposes ceased as the USA let it be know that they were unwilling to exchange gold for the dollar reserves held by other countries. This was compounded by inflationary pressure primarily caused by the financing of the Vietnam war which from the mid-1960s onwards put unbearable pressure on the system.

12. The 'snake' was a mechanism to reduce intra-EC exchange rate fluctuations. Bilateral fluctuations among EC members was halved from the 9 per cent band of the Smithsonian agreement to a 4.5 per cent band.

13. Germany was keen on monetary integration because at that time the USA was in recession and the dollar was weak. The Americans were applying pressure on the German government to reflate the economy to assist international economic recovery. Although Germany was fearful of the impact of reflation on monetary stability, there was greater concern for the strains that rebuffing America's demands would have on their political and security alliance. Monetary integration provided Germany with the answer, it allowed the strains of reflation to be spread over the whole community (Pinder, 1996, p. 130).

14. In the political arena, the European Political Cooperation (EPC) was established to coordinate foreign policy. Because of the political sensitivities involved the EPC remained at an intergovernmental level with a minimal role for the Commission and the European Parliament.

15. Britain was one of the poorer countries in the EEC in terms of GNP per head, yet it was the second largest net contributor. A solution to this problem was reached at the Fontainebleau meeting of European Council in June 1984.

16. Enlargement of the EC coupled with the Single Market programme would have seriously aggravated the economic and social divide between richer and poorer countries.

17. In 1966 the EC was unable to compromise on proposals put forward by the Commission. France objected to the increase in the powers of community's institutions that one proposal would entail. Subsequently France left its chair empty at the Council of Ministers. After seven months a compromise was reached about decision-making in the Council of Ministers, essentially this gave countries the right of veto when they national interest were concerned.

18. From 1970 member states used procedures termed European Political Cooperation to discuss and coordinate their position on foreign affairs to act in unison.

19. The CBG and the EMCF merged in January 1994 to form the EMI at stage 2 of EMU.

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