Lecture 1

The History of Monetary Integration in Europe

Looking back from the European Monetary Union, which was established in 1999, the objective of creating 'an ever closer union' has been clearly achieved in the monetary sphere of the economy. At the present time, the euro area consists of 13 member states whose economic potential is comparable to the United States. Moreover, the euro increasingly serves as a vehicle currency and a reserve currency in international relations and, in these functions, competes with the US dollar.

The history of monetary integration in Europe distinguishes different phases which do not demonstrate a direct line of continuing development but to the contrary are characterised by fall-backs and bypasses. Studying these phases, we recognise two features of monetary integration. First, monetary integration takes place in interaction with economic integration. There is a mutual relationship, economic and monetary integration reinforcing each other. Secondly, we learn that monetary integration is bound to the establishment of new institutions.

After World War II, monetary integration in Europe started with the creation of the European Payments Union in 1950. The payments union provided the precondition for the expansion of trade in Europe, but also served as a framework for macroeconomic policy coordination. When the European Economic Community was founded in 1958, the payments union was closed since the currencies of the participating countries had reached convertibility. In the following
period, macroeconomic policy coordination ceased, and the Bretton Woods System of fixed exchange rates provided the only framework for European central banks to adjust their monetary policies. The currency system of Bretton Woods which came into existence in 1944 in order to supply sufficient international liquidity after the war gave a predominant role to the US dollar. In 1971, when the US government refused to subordinate its internal objectives to the requirements of the currency system, the system collapsed. Consequently, the period of fixed albeit adjustable exchange rates ended also for the European currencies. The objective of monetary integration in Europe had now to be pursued under conditions of a currency competition. A currency system of flexible exchange rates, which has been called a ‘system of no commitments’ (De Grauwe), allows a country only on the first view to pursue its own macroeconomic policy objectives. The reason is that flexible exchange rates tend to be volatile—to the contrary of what textbooks are teaching. So, a highly integrated economic area like the European Community had to re-establish monetary conditions which were favourable to trade. Consequently, a political consensus evolved to coordinate monetary policies and to establish a European system of fixed exchange rates. The European Monetary System was eventually founded in 1979, after some half-minded attempts of stabilising exchange rates between European currencies turned out to be unsuccessful. The European Monetary System was modelled unlike the Bretton Woods System to avoid its failures but from the beginning it was endangered by a lack of an adequate coordination of macroeconomic policies. When these impediments were overcome during the 1980s, the system proved to be a reliable basis to erect a monetary union.

1.1 The European Payments Union (EPU), 1950-1958

- Steps towards convertibility
- Integration by trade requires solvency
- EPU is established as a multilateral clearing system, to overcome bilateralism