CHAPTER 2

Rules and Norms of European Monetary Cooperation

Explaining European Monetary Cooperation

What drives monetary integration? Countries can participate in a variety of systems, ranging from general statements of support for economic cooperation and policy coordination, to the extreme case of monetary union. A fixed-but-adjustable exchange rate peg like the EMS fell in between these two poles by offering participants some flexibility. In the EMS, countries were able to periodically realign the exchange rate to adapt to changes in the monetary environment. Under the best of circumstances, this would mean that participants would enjoy the benefits of exchange rate stability such as enhanced trade and investment flows due to the removal of exchange rate uncertainty, without entirely sacrificing the exchange rate as an adjustment tool. The delegation of monetary policy to a more credible institution than a national finance ministry or a national central bank (such as the central bank of another country within the exchange rate agreement) also could make monetary policy announcements more credible, thus allowing lower interest-rate premiums and making it easier to achieve price stability.

Monetary union both offers more rewards and poses more risks for countries. On the one hand, monetary union eliminates the risk of exchange rate pegs becoming less credible against one another and generating speculative attacks against their respective currencies (as they share a single currency). When an arrangement demands financial support from participating governments (as the EMS did), market speculation can be quite costly for both the country with the weak
currency and the country with the strong currency. A single currency also offers the region greater autonomy in the international monetary realm and makes it less prone to fluctuations from other currencies. This promotes trade within the region, further strengthening the ties between the countries and potentially leading to the synchronization of participating economies and their business cycles (Frankel and Rose 1998). These positive effects of monetary integration contribute to further regional cooperation and lead to even more intra-regional trade and investment.

On the other hand, monetary union removes the exchange rate as a tool of adjustment because it demands a single monetary policy. If the composite regions are not sufficiently integrated, economic shocks that affect the region asymmetrically cannot be offset with exchange rate changes. Economic theory therefore points to the importance of states that share a currency to form an optimum currency area (Mundell 1961). If a region forms such an area, this indicates that a single monetary policy could be used in the adjustment process for an economic shock that affects the region similarly; or, in the case of an asymmetric shock, that adjustment could be facilitated via labor mobility or with the use of fiscal transfers. High labor mobility and the ability to make fiscal transfers are thus two potential indicators of an optimum currency area, along with the trade patterns of the constituent components of the area and the level of synchronization of business cycles. Though economists have argued that the existing members of EMU did not form such an optimum currency area (Eichengreen 1992a), the intensified trade patterns and expected higher correlation of business cycles in a post-EMU environment could rectify this situation in the future (Frankel and Rose 1998).

However, though monetary integration can offer these benefits that ultimately lead to greater trade and investment and therefore better long-term growth prospects, in the short to medium term there will be actors whose interests may be harmed by such exchange rate commitments and will try to impede its progression. At the international level, some states will benefit more than others because they will pay fewer costs while enjoying the benefits. Fixed exchange rate systems have leaders (also known as the anchor) and followers. The anchor currency can make monetary policy without regard to the monetary policy of the followers (known as the “n minus one problem” in the economics literature). Costs to the anchor currency vary according to the type of commitment it has made to other countries in the exchange rate agreement. In the case where a country unilaterally pegs its currency to